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NAESB Contract Not Protected by Bankruptcy Code Safe Harbor Provisions

October 8, 2007

The decision of the U.S. Bankruptcy Court in *Hutson v. Smithfield Packing Co. (In re National Gas Distributors, LLC)*[1] poses potentially serious problems for parties trading gas under the North American Energy Standards Board (NAESB) base contract. The U.S. Court of Appeals for the Fourth Circuit will soon review this case of first impression about what constitutes a "swap agreement" under the expanded definition included in the U.S. Bankruptcy Code after the 2005 amendments. That ruling could affect market participants trading gas and other physical commodities, as the International Swaps and Derivatives Association, Inc., (ISDA) recently warned:

> [T]he Bankruptcy Court's narrowing of the scope of the Bankruptcy Code's "safe harbors" with respect to derivative transactions will have a disruptive and deleterious effect on the financial markets. . . . The Bankruptcy Court's ruling as a matter of law that the contract between National Gas Distributors and Smithfield was not a "swap agreement" but rather a "supply agreement" and therefore does not fall within the newly expanded Bankruptcy Code definition of swap agreement is contrary to both the express language of the Bankruptcy Code and Congressional intent. That the Bankruptcy Court chose this path by analogizing the large-scale, future-priced contract to "the smallest case of a farmer who contracts to sell his hogs at the end of the month for a fixed price" is particularly confusing. This confusion is heightened by the absence of fact finding. The Bankruptcy Court's ruling has drawn a great deal of attention in the industry and needs to be addressed as soon as possible so that a clear precedent on this new and important provision can be established.

Perhaps most importantly, the decision reiterates the wisdom of knowing your counterparty, because in *National Gas,* the debtor was allegedly engaged in an effort to intentionally defraud creditors.

In *National Gas*, the court concluded that the NAESB contract at issue was not a "swap agreement" protected from the trustee's avoidance powers under the safe harbor provisions of sections 546 and 548 of the Bankruptcy Code. The court also *in dicta* concluded that the NAESB contract at issue was not a "forward contract," but that *dicta* rests on an interpretation of the Code's definition of "forward contract" that has since been revised.

This decision (even if it survives appeal) may have limited impact, given the particulars of the case. Nevertheless, this decision points out the substantial uncertainty surrounding the issue of whether term agreements for physical commodities qualify for the Code's safe harbor protections, especially where the non-debtor party is an end user or supplier (as distinguished from a marketer or reseller). In *National Gas*, the Chief Bankruptcy Judge for the Eastern District of North Carolina concluded that whatever a "swap agreement" may be, it does "not include contracts between a seller and an end user for delivery of a product that happens to be a recognized commodity."

The trustee in National Gas Distributors' bankruptcy brought avoidance actions against Smithfield Packing Company and more than 20 other former customers of National Gas, seeking to recover the value of natural gas sold by the debtor in the year preceding the bankruptcy. The sales to Smithfield were governed by an NAESB agreement, and were allegedly at below market prices. The trustee alleged the debtor's sales and delivery of gas to the counterparties were part of an actual intent to defraud creditors, or alternatively a constructive fraud, which the trustee could avoid under section 546 and 548.

In this effort to recover for the debtor's estate, Smithfield became a test case for 23 other cases. Two other defendants filed motions to dismiss, but given the similarity of the cases, the court decided to hear arguments on the Smithfield matter and let that decision govern those other cases. The trustee's complaint alleged that National Gas, as part of a fraudulent scheme, sold natural gas to some of its customers, including Smithfield, at below market prices. Specifically with respect to Smithfield, the trustee alleged that during the 12 months preceding the filing of the bankruptcy petition, the debtor sold natural gas to Smithfield at below market prices (at the time of the sale) resulting in an aggregate loss to National Gas of approximately $2,144,750.

The trustee alleged that the sales were made by National Gas with the intent to hinder, delay and defraud creditors. The fraud allegedly included below-market sales, false invoices, false reporting of invoices to the debtor's secured lenders and obtaining loans on the basis of false information. According to the trustee, those alleged facts show actual fraud and support avoidance of the transfers pursuant to § 548(a)(1)(A). The trustee also alleged that at the time of the transfers, National Gas was insolvent, and because the sales were made at a price below market value, National Gas did not receive reasonably equivalent value for the natural gas that it sold, which the trustee maintains effected constructively fraudulent transfers avoidable under § 548(a)(1)(B).

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[1] 2007 WL 1531616 (Bankr. E.D.N.C.)

Smithfield sought to dismiss the trustee's complaint, raising the safe harbor provisions of sections 546 and 548 of the Code for forward contracts and swap agreements. All parties and the court agreed that if the NAESB contract between the debtor and Smithfield was a "swap agreement" between swap participants, the trustee's suit would fail due to the limitation on avoidance power for swap agreements.

Successfully characterizing the underlying contract as a "swap agreement" would defeat the trustee's constructive fraud claim, because section 546(g) provides a safe harbor for any payments under a swap, whereas section 546(e)—a similar safe harbor provision applicable to "forward contracts"—protects only margin or settlement payment. It also would defeat the trustee's actual fraud claim because section 548(d)(2)(D) presumes that a swap participant that receives a transfer in connection with a swap agreement takes for value to the extent of such transfer, and 548(c) makes non-avoidable transfers received for value in good faith.

The meaning of several Code terms took center stage in the decision. Smithfield argued that the NAESB contract was a "forward contract" and therefore was a "forward agreement," which is included in the definition of a "swap agreement." The court declined to bite on Smithfield's argument. The trustee conceded the NAESB was a forward contract, but disputed that it was a forward agreement (which is not defined in the Code). The court was, however, reluctant to accept that the base contract was a "forward contract." But even accepting that it was, the court still concluded the base contract was in fact not a "swap agreement."

The trustee argued that even if the base contract was a "forward contract," it was not a "swap agreement:"

> The fundamental error in Defendant's analysis is its contention that the agreements for the delivery of natural gas were 'forward contracts" between the Debtor and Defendant, and that forward contracts necessarily constitute "swap agreements" when in fact, the contractual arrangement at issue here is nothing more than a series of agreements between a supplier and an end user for the purchase of a commodity to be delivered at an agreed upon price in the future.

The trustee submitted an expert report contending that "no market would recognize the [NAESB] contract between the parties in the present case as a swap." The distinction between forward contracts for physical use of natural gas and swap agreements is critical because the protections afforded parties to forward contracts by section 546(e) are more limited than the protections afforded parties to swap agreements by section 546(g). Under the latter, all payments to a swap participant are protected, but only margin or settlement payments are protected for forward contracts.

The court characterized the NAESB contract as a "simple supply contract for the sale of natural gas by one party, National Gas, to another, Smithfield." The trustee (in opposing Smithfield's efforts to stay discovery pending appeal) characterized Smithfield's argument as contending that the Bankruptcy Code, as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), "now contains a bright-line rule that any agreement for the sale of a commodity to be delivered more than days after the date of the agreement is a 'swap agreement' and protected from the trustee's power to avoid fraudulent transfers." The trustee portrayed such an interpretation as "elevate[ing] every simple supply agreement involving the sale of a commodity on terms other than cash-and-carry to the level of a financial derivative protected from avoidance action."

In siding with the trustee's argument that the NAESB contract, although a forward contract, was not a forward agreement, the court also cited confusing language in the definition of forward contract:

> To complicate things further, the definition of forward contract excludes a "commodity contract." § 101(25). All parties agree that natural gas is a commodity. The term commodity contract is not defined and could reasonably be interpreted to mean a contract involving a commodity to be delivered in the future, but one that is not "the subject of dealing in the forward contract trade." For both of these reasons, the court believes that a simply supply contract should not be included within the definition of a forward contract.

In characterizing the NAESB contract as a simple supply contract for physical gas, *National Gas* rejected the U.S. Court of Appeals for the Fifth Circuit's decision in *Williams v. Morgan Stanley Capital Group Inc. (In re Olympic Natural Gas Co.)*[2] and the bankruptcy court's decision in *In re Mirant Corp.*[3] According to *National Gas*

> The contract in *Olympic Natural Gas* was a "Natural Gas Sales and Purchase Contract" which provided that "each month the parties would enter into a series of individual transactions, in which each would act sometimes as buyer and sometimes as seller, after agreeing the price, quantity, timing, and delivery point for the natural gas." One of the parties to the contract, Morgan Stanley Capital Group, was not a supplier of natural gas, but acted as both buyer and seller under the contract. The contract in that case clearly was not an actual supply contract.

Olympic Natural Gas and *Mirant* both found a basis not to construe "forward contract" as excluding "commodity contracts" and still preserve the safe harbor provisions for the agreements at issue. But *National Gas* concluded that those courts were wrong based on a "plain meaning" read of Code Section 101(25), which at that time did not yet specify that the term "commodity contract," as used in the definition of "forward contract," has the meaning prescribed by Code Section 761(4).

National Gas sought to justify its decision with "textualism" by cloaking the result in the equality of treatment for like creditors principle underlying the Code:

> The court's conclusion that the contract at issue is not within the definition of a swap agreement also comports with an important guiding principle for all bankruptcy courts, which was recently emphasized by the United States Supreme Court in *Howard Delivery,* 126 S.Ct. at 2109. The Court stated that "the Bankruptcy Code aims, in the main, to secure equal distribution among creditors." In that case, the Court concluded that it was "far from clear" that an employer's liability to provide worker's compensation coverage came within the language of § 507(a)(5), which confers priority for contributions to an employee benefit plan arising from services rendered. 126 S.Ct. at 2116. For that reason, and because other factors also weighed against that categorization, the Court determined that "any doubt concerning the appropriate characterization . . . is best resolved in accord with the Bankruptcy Code's equal distribution aim." 126 S.Ct. at 2116. Affording to the trustee the full range of his statutory avoidance powers, on the facts before the court, is in line with both the Code's goal of equal distribution and "the complementary principle that preferential treatment of a class of creditors is in order only when clearly authorized by Congress." 126 S.Ct. at 2109.

Critically, *National Gas* limited the applicability of its ruling to bankruptcy petitions filed prior to the effectiveness of the 2006 amendments to the Code contained in the Financial Netting Improvement Act of 2006. Those amendments revised the Code to clarify that the term "commodity contract" in the definition of "forward contract" has the meaning given in Section 761(4):

> [T]he fact remains that Congress did not refer to § 761(4) either in 1990 or in 2005 when the definition of "forward contract" was amended by BAPCPA. Section 101(25)(A) was amended by the Financial Netting Improvements Act of 2006, Pub.L. 109-390, § 5(a)(1)(C)(i), and now provides that "commodity contract" is defined in § 761. The 2006 amendment is not applicable in this case, because the case was filed prior to the amendment's effective date of December 12, 2006.

Given the current state of the Code and the bankruptcy judge's affirmative restriction of his decision to the contract at hand, the significance of this decision should be limited. Nevertheless, *National Gas* raises significant concerns for parties—especially end users and producers—whose counterparties are in bankruptcy proceedings not governed by the 2006 revisions. Not only is the risk of avoidance actions greater under *National Gas*, but the ability of a party to a NAESB contract to walk away from a bankrupt counterparty could be in doubt. Considering the import of this decision, on September 12, 2007, Smithfield was granted leave to pursue an appeal directly to the U.S. Court of Appeals for the Fourth Circuit in Richmond, Virginia. In the meantime, skirmishes continue before the lower courts about whether to allow discovery and pretrial matters, the results of which could prejudice the appeal. It is important for the Court of Appeals to address this issue, and a prompt decision on that appeal will hopefully assuage concerns about the lingering uncertainty.

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[2] 294 F.3d 737 (5th Cir. 2002)

[3] 310 B.R. 548 (2004)

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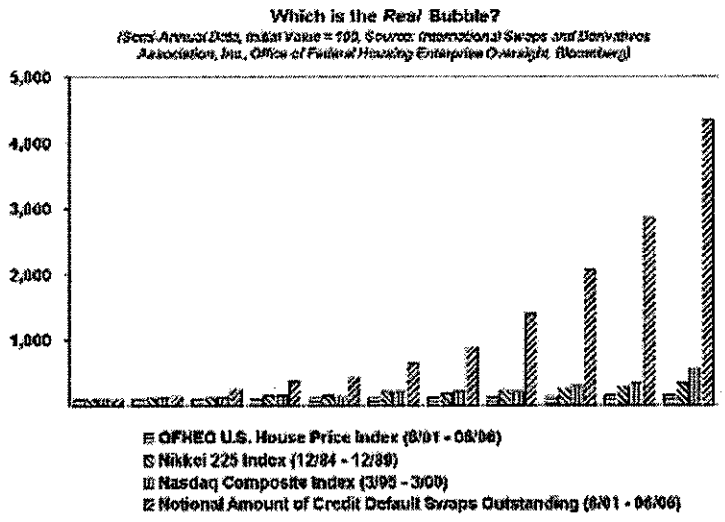
Friday, June 1, 2007 | Posted By | |

Judge Small Rules That Ordinary Commodity Supply Contracts Are Not "Swap Agreements" Under BAPCPA

BAPCPA's least appreciated (and understood) changes, despite their enormous impact on financial markets generally, are the changes designed to strengthen and clarify the enforceability of various types of financial derivatives contracts. To provide enhanced protection to the financial services industry, Congress added or expanded the Code's definitions for such industry staples as "forward contracts" (§101(25)), "repurchase agreements" (§101(47)), and "swap agreements" (§101(53B)). Various other Code provisions were amended or added to reflect Congress's desire to enable a nondebtor party–without hesitation–to terminate, liquidate or accelerate its securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements or master netting agreements with the debtor. (*See generally,* these few pages of professor, lawyer, Code co-architect, and energy healer Ken Klee's excellent summary of BAPCPA's amendments to the Code's business-related provisions).



Columbia Law professor Edward Morrison, with Columbia GSB economics legend Franklin Edwards, argue in a Winter 2005 article entitled *Derivatives and the Bankruptcy Code: Why the Special Treatment?* that BAPCPA's extension of the Code's protections for the financial services industry "to include a broader array of financial contracts, all in the name of reducing systemic risk ... is a mistake." Rather, they argue, "[a] better, efficiency-based reason for treating derivatives contracts differently arises naturally from the economic theory underlying the automatic stay [*i.e.*, derivative contracts are rarely needed to preserve a firm's going-concern surplus]." Still, they warn (at p.1):

> There are, however, downsides to treating derivatives contracts differently (creditors, for example, would like to disguise loans as derivatives contracts). These downsides are probably not signficant, but they highlight the fragility of the Code's treatment of derivatives contracts, which should worry members of Congress as they consider arguments to expand the Code's exemptions for derivatives contracts.

After BAPCPA became law, Professor Morrison teamed with Columbia LLM candidate (and now Davis Polk associate) Joerg Riegel to author another article entitled *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*. They wrote that BAPCPA did not just "eliminate longstanding uncertainty surrounding the protections available to financial contract counterparties, especially counterparties to repurchase transactions and other derivatives contracts" Rather, they observed, "the ambit of the reforms is much broader," especially

because of the newly expanded definition of "swap agreement," which they termed "so broad that nearly every derivative contract is subject to the Code's protection." (p.1). Notably, however, this conclusion was later called into question (though not expressly) by Thompson & Knight's Rhett Campbell in a 2005 article entitled *Financial Markets Contracts and BAPCPA*. He wrote that "even though the definitions themselves are often nothing more than a listing of labels with little attempt at a functional definition, the legislative history shows an intent to prevent parties from obtaining the benefits of financial contracts safe harbors merely by the judicious use of labels." 79 Am. Bankr. L. J. 697, 705 (2005).

In commenting on the impact of these reforms on the bankruptcy judiciary, Morrison and Riegel concluded (pp. 4-5):

> Equally important, the amendments limit judicial discretion to assess the economic substance of financial transactions, even those that resemble ordinary loans or that retire a debtor's outstanding debt or equity. The reforms of 2005 direct judges to apply a formalistic inquiry based on industry custom: a financial transaction is a "swap," "repurchase transaction," or other protected transaction if it is treated as such in the relevant financial market....
>
> Indeed, if anything is clear from the new Code, it is that judges are strongly discouraged from engaging in functional analysis of financial contracts. The Code's protections encompass contracts or combinations of contracts that differ little in substance from unprotected transactions, such as secured loans. They are protected because they are recognized in financial markets as financial contracts. Any judicial effort to distinguish protected and unprotected contracts based on their "substance" is doomed to failure and can only generate significant uncertainty in the very markets the Code seeks to protect. By relying on broad market definitions, the Act gets judges out of the (largely futile) business of second-guessing financial contracts. Absent evidence of intent to defraud a debtor's creditors, which remains ground for denying protection to payments under a financial contract, the new role of judges is to apply industry custom to financial contracts in much the same way that they would apply custom to interpret a contract under the Uniform Commercial Code.

Maybe it's just Professor Morrison's year of clerking for Justice Scalia that has jaded him, but most bankruptcy judges I know don't "apply a formalistic inquiry," especially when it comes to interpreting BAPCPA! (*See also,* the opinions of Judge Bruce A. Markell (here and here) and the 60 pages of handouts on principles of statutory construction that the Southern District of Ohio's Chief Bankruptcy Judge, Thomas F. Waldron, penned for last year's NCBJ confab). In this regard, it's worth considering the words of the Eastern District of North Carolina's Chief Bankruptcy Judge A. Thomas Small in *In re Donald,* 343 B.R. 524 (Bankr. E.D.N.C. 2006) (pdf), where he had this to say about interpreting BAPCPA:

> Unfortunately, the BAPCPA amendments ... are confusing, overlapping, and sometimes self-contradictory. They introduce new and undefined terms that resemble, but are different from, established terms that are well understood. Furthermore, the new provisions address some situations that are unlikely to arise. Deciphering this puzzle is like trying to solve a Rubik's Cube that arrived with a manufacturer's defect. [Ed. Note: This one is sure to work.] Fortunately, after many twists and turns, a few patches of solid color emerge. *Id.* at 529.

Judge Small's opinion last week in *Hutson v. Smithfield Packing Co. (In re Nat'l Gas Distributors, LLC)*, 2007 WL 1531616 (Bankr. E.D.N.C. 5/24/07) (pdf) partially resolved BAPCPA's puzzle regarding the

scope of the "swap agreement" amendments to the Code surprisingly easily, but not because he "appl [ied] a formalistic inquiry." Rather, in deciding whether BAPCPA's expanded definition of "swap agreement" to include "forward agreements" would preempt an avoidance action against a nondebtor customer who received natural gas from the debtor under a below-market commodity contract, Judge Small concluded:

> As the foregoing discussion illustrates, the court cannot rely on the plain language of the statute. The term "forward agreement" is not in everyday usage, its meaning is uncertain, and the court must consider other rules of statutory interpretation.

So what did he rely on if not the "plain language of the statute"? As suggested in Judge Waldron's outline, the legislative history, of course! Notably, that there even was some relevant legislative history to look to was itself a great surprise to Judge Small, who wrote:

> A review of the relevant statute's history is in order. See *Toibb [v. Radloff]*, 501 U.S. at 162, 111 S.Ct. at 2200 (explaining that where the "resolution of a question of federal law turns on a statute and the intention of Congress, we look first to the statutory language and then to the legislative history if the statutory language is unclear") (internal quotations omitted)....
>
> The definition applicable to the issue before the court is, of course, the post-BAPCPA definition, which is more expansive. Why did Congress expand the definition of swap agreement? Legislative history is available and, in contrast to most of BAPCPA's legislative history which merely repeats the statute, the legislative history attempts to explain why the statute was enacted and what the statute means. Unfortunately, the guidance of the legislative history itself is contradictory.

To Judge Small, the legislative history resolved the matter in the trustee's favor in two ways. First, he noted, Congress never intended that ordinary supply agreements would be swept into the definition of "swap agreements":

> Congress ... clearly stated ... that it did not intend for supply agreements to be swept into the realm of swap agreements. The restrictive reference to recurrent trade, taking place in the swap markets, means that Congress was focused on financial instruments that are themselves regularly the subject of trading, and did not contemplate application of this statute to a contract of the kind at issue here, which is simply an agreement by a single end-user to purchase a commodity.

Further, applying a corollary canon of statutory construction (*i.e.*, that statutory construction is a holistic endeavor and thus a statute must be read in its context, not in isolation), Judge Small found additional reason to exclude the contract from the protections afforded "swap agreements," stating:

> In construing the statute, the court also must, of course, "consider the context in which the statutory words are used because '[w]e do not ... construe statutory phrases in isolation; we read statutes as a whole.' *Ayes v. U.S. Dep't of Veteranas Affairs*, 473 F.3d 104, 108 (4th Cir. 2006). Here, the context is readily evident: This statute is meant to protect financial markets. Though Smithfield would have the court end the inquiry with the limited language of § 101(53B)(A)(i)(VII), which provides that a swap agreement includes "a commodity index or a commodity swap, option, future or forward agreement," putting the statute in its actual, appropriate context reveals that there is much more to the statutory definition.

> It is true enough that § 101(53B)(A)(i) lists numerous agreements that fall within the definition of "swap agreement." Section 101(53B)(A)(ii) provides for additional agreements or transactions that are "similar" to those referred to in § 101(53B)(A)(i) and are the subject of recurrent dealings in the swap market and are forwards, swaps, futures, or options "on one or more rates, currencies, commodities, equity securities, or other equity instruments ..." The word "similar," rather than expanding the universe of agreements that come within the umbrella of swap agreements, actually limits the agreements to those that "bear[ ] a family resemblance" to the other agreements and transactions that enjoy the protections of the Bankruptcy Code. *Ayes*, 473 F.3d at 108. The other agreements described in § 101(53B)(A)(i) are found in financial markets. They do not include contracts between a seller and an end-user for delivery of a product that happens to be a recognized commodity.

Finally, though none of the parties raised this important reference, Judge Small hearkened back to the happier days of yore when Justice Ginsburg and Justice Scalia could find common ground, as they did in *Howard Delivery Serv., Inc. v. Zurich American Ins. Co.*, 126 S. Ct. 2105 (2006) (pdf) (reviewed at length here), where both agreed that "plain meaning" in the bankruptcy context must be viewed through special bankruptcy bifocals. Quoting Justice Ginsburg, Judge Small concluded:

> The court's conclusion that the contract at issue is not within the definition of a swap agreement also comports with an important guiding principle for all bankruptcy courts, which was recently emphasized ... in *Howard Delivery*, 126 S. Ct. at 2109. The Court stated that "the Bankruptcy Code aims, in the main, to secure equal distribution among creditors." In that case, the Court concluded that it was "far from clear" that an employer's liability to provide worker's compensation coverage came within the language of § 507(a)(5), which confers priority for contributions to an employee benefit plan arising from services rendered. 126 S. Ct. at 2116. For that reason, and because other factors also weighed against that categorization, the Court determined that "any doubt concerning the appropriate characterization ... is best resolved in accord with the Bankruptcy Code's equal distribution aim." 126 S. Ct. at 2116. Affording to the trustee the full range of his statutory avoidance powers, on the facts before the court, is in line with both the Code's goal of equal distribution and "the complementary principle that preferential treatment of a class of creditors is in order only when clearly authorized by Congress." 126 S. Ct. at 2109.
>
> Both parties have made solid arguments to support their positions, but it is not clear to the court that the definition of swap agreement is broad enough to cover the contract between National Gas and Smithfield. Resolution of this case, as with *Howard Delivery*, turns on the "essential character" of the market protection statutes at issue. 126 S. Ct. at 2113. Because the contract is not clearly within the definition of swap agreement, the court will not upset the priority scheme of the Bankruptcy Code by affording the transfers under the contract the protections afforded to swap agreements and swap participants under § 546(g), and under § 548(c) and § 548(d)(2)(D).

* * *

From a litigation perspective, the parties' positions were advanced through these well-crafted briefs:

- Memorandum in support of motion to dismiss by Smithfield Packing
- Response of Trustee

The pleadings also captured the attention of the International Swaps and Derivatives Association, which filed this *amicus* brief in support of dismissal of the adversary complaint. Here's a nice link from the ISDA site showing the explosion of derivative contracts in the past 20 years (from $800 billion in aggregate notional amount at the end of 1987 to $300 trillion in aggregate notional amount at the end of 2006).

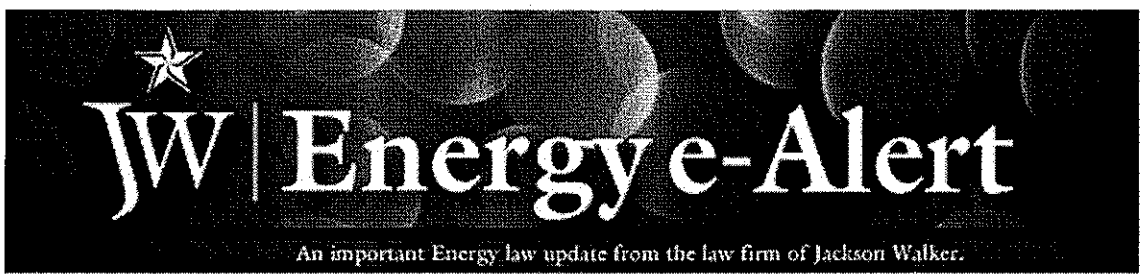
An interesting aside related to whether the affidavit and report submitted by the Trustee of its expert, Claire P. Gotham, should be stricken because her conclusion that the contracts at issue were not "swap agreements" was a question of law, thus rendering her affidavit irrelevant under FRE 401. Here's the Defendant's motion to strike and the Trustee's response.

The trustee also submitted this remarkable expert report of its accountant, Neal Bradsher & Taylor, documenting the depth of the fraud perpetrated by insiders that led to the Debtor's filing.

Many thanks to Judges Waldron and Markell for permission to publish here the materials they disseminated at the 2006 NCBJ entitled: *Principal Principles of Principled Decisions: Statutory Construction and BAPCPA*.

Thanks also to the Commercial Law League of America and BAPCPA guru Cathy Vance for making available online Cathy's short reference piece entitled "Some Canons of Statutory Construction."

The inset graph is taken from useful insights and links (9/24/06) at Michael Panzer's website for his book, *The New Laws of the Stock Market Jungle*.



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Court Limits Scope of "Forward Contracts"

By Craig Enochs and Bruce Ruzinsky

A North Carolina bankruptcy court recently held that a NAESB master agreement and the natural gas sales transactions thereunder did not constitute a "forward contract" and therefore were not a "swap agreement" under the U.S. Bankruptcy Code. As a result, the creditor was not entitled to the safe harbor that swap agreements enjoy from being attacked as fraudulent transfers.

In *In re National Gas Distributors, LLC* (2007 WL 1531616 (Bktrcy.E.D.N.C.)), National Gas and Smithfield Packing Company entered into multiple transactions for the sale of natural gas to Smithfield pursuant to a NAESB Base Contract for Sale and Purchase of Natural Gas during the 12-month period prior to National Gas' bankruptcy filing. At the time of the bankruptcy filing, these transactions were out-of-the-money for National Gas. The bankruptcy trustee claimed that these transactions constituted fraudulent transfers to Smithfield. Smithfield filed a motion for summary judgment asserting that the transactions were not avoidable on fraudulent transfer grounds because they constituted swap agreements that are excepted from avoidance pursuant to sections 546(g), 548(c), and 548(d)(2)(D) of the Bankruptcy Code. An *amicus curiae* brief was filed by ISDA in support of Smithfield's position. The Court denied the motion on the grounds that "the contract is not clearly within the definition of [a] swap agreement." *15.

The Court in National Gas examined the 5th Circuit's decision *In re Olympic Natural Gas Co.*, 294 F.3d 737 (5th Cir.2002), which held that natural gas transactions under a NAESB are forward contracts. It then proceeded to distinguish the two cases on the grounds that (i) *Olympic Natural Gas* involved transactions where each of the parties were buyers under some of the transactions and sellers under others, while the transactions in *National Gas* all involved National Gas as the seller and Smithfield as the buyer and (ii) the *Olympic Natural Gas* case concerned section 546(e) of the Bankruptcy Code while the *National Gas* case concerned section 548(a) of the Bankruptcy Code.

This decision demonstrates that the analysis set forth in *Olympic Natural Gas* has not been accepted universally by other courts. Some courts remain skeptical that Congress intended "forward contract" and "swap agreement" to be construed as broadly as some energy industry participants, and industry organizations such as ISDA, intend them to be. As a result, parties to retail energy commodity transactions should not assume that these transactions will be treated as forward contracts and/or swap agreements by a bankruptcy court. This applies even where the parties to retail energy commodity transactions agree in their contract that the contract is a forward contract, as they did in the *Natural Gas* case.

If you have any questions about this case or would like any more information about this issue, please feel free to call **Craig Enochs** at 713.752.4315 or **Bruce Ruzinsky** at 713.752.4204.

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Smithfield Decision Raises Concerns For NAESB

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The U.S. Court of Appeals for the Fourth Circuit will soon review this case of first impression about what constitutes a "swap agreement" under the expanded definition included in the U.S. Bankruptcy Code after the 2005 amendments.

That ruling could affect market participants trading gas and other physical commodities, as the International Swaps and Derivatives Association Inc. (ISDA) recently warned:

"[T]he Bankruptcy Court's narrowing of the scope of the Bankruptcy Code's 'safe harbors' with respect to derivative transactions will have a disruptive and deleterious effect on the financial markets. ... The Bankruptcy Court's ruling as a matter of law that the contract between National Gas Distributors and Smithfield was not a 'swap agreement' but rather a 'supply agreement' and therefore does not fall within the newly expanded Bankruptcy Code definition of swap agreement is contrary to both the express language of the Bankruptcy Code and congressional intent.

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In National Gas, the court concluded that the NAESB contract at issue was not a "swap agreement" protected from the trustee's avoidance powers under the safe harbor provisions of sections 546 and 548 of the Bankruptcy Code. The court also in dicta concluded that the NAESB contract at issue was not a "forward contract" but that dicta rests on an interpretation of the Code's definition of "forward contract" that has since been revised.

This decision (even if it survives appeal) may have limited impact, given the

particulars of the case. Nevertheless, this decision points out the substantial uncertainty surrounding the issue of whether term agreements for physical commodities qualify for the Code's safe harbor protections, especially where the non-debtor party is an end user or supplier (as distinguished from a marketer or reseller).

In National Gas, the Chief Bankruptcy Judge for the Eastern District of North Carolina concluded that whatever a "swap agreement" may be, it does "not include contracts between a seller and an end user for delivery of a product that happens to be a recognized commodity."

The trustee in National Gas Distributors' bankruptcy brought avoidance actions against Smithfield Packing Company and more than 20 other former customers of National Gas, seeking to recover the value of natural gas sold by the debtor in the year preceding the bankruptcy.

The sales to Smithfield were governed by an NAESB agreement and were allegedly at below-market prices. The trustee alleged the debtor's sales and delivery of gas to the counterparties were part of an actual intent to defraud creditors, or alternatively a constructive fraud, which the trustee could avoid under section 546 and 548.

In this effort to recover for the debtor's estate, Smithfield became a test case for 23 other cases.

Two other defendants filed motions to dismiss, but, given the similarity of the cases, the court decided to hear arguments on the Smithfield matter and let that decision govern those other cases.

The trustee's complaint alleged that National Gas, as part of a fraudulent scheme, sold natural gas to some of its customers, including Smithfield, at below-market prices. Specifically with respect to Smithfield, the trustee alleged that during the 12 months preceding the filing of the bankruptcy petition, the debtor sold natural gas to Smithfield at below-market prices (at the time of the sale) resulting in an aggregate loss to National Gas of approximately $2,144,750.

The trustee alleged that the sales were made by National Gas with the intent to hinder, delay and defraud creditors. The fraud allegedly included below-market sales, false invoices, false reporting of invoices to the debtor's secured lenders and obtaining loans on the basis of false information. According to the trustee, those alleged facts show actual fraud and support avoidance of the transfers pursuant to § 548(a)(1)(A).

The trustee also alleged that at the time of the transfers, National Gas was insolvent, and because the sales were made at a price below market value, National Gas did not receive reasonably equivalent value for the natural gas that it sold, which the trustee maintains affected constructively fraudulent transfers avoidable under § 548(a)(1)(B).

Smithfield sought to dismiss the trustee's complaint, raising the safe harbor provisions of sections 546 and 548 of the Code for forward contracts and swap agreements. All parties and the court agreed that if the NAESB contract between the debtor and Smithfield was a "swap agreement" between swap participants, the trustee's suit would fail due to the limitation on avoidance power for swap agreements.

Successfully characterizing the underlying contract as a "swap agreement" would defeat the trustee's constructive fraud claim because section 546(g) provides a safe harbor for any payments under a swap, whereas section 546(e) — a similar safe harbor provision applicable to "forward contracts" — protects only margin or settlement payment.

It also would defeat the trustee's actual fraud claim because section 548(d)(2)(D) presumes that a swap participant that receives a transfer in connection with a swap agreement takes for value to the extent of such transfer, and 548(c) makes non-avoidable transfers received for value in good faith.

The meaning of several Code terms took center stage in the decision.

Smithfield argued that the NAESB contract was a "forward contract" and therefore was a "forward agreement," which is included in the definition of a "swap agreement." The court declined to bite on Smithfield's argument.

The trustee conceded the NAESB was a forward contract but disputed that it was a forward agreement (which is not defined in the Code). The court was, however, reluctant to accept that the base contract was a "forward contract." But even accepting that it was, the court still concluded the base contract was in fact not a "swap agreement."

The trustee argued that even if the base contract was a "forward contract," it was not a "swap agreement":

"The fundamental error in Defendant's analysis is its contention that the agreements for the delivery of natural gas were 'forward contracts' between the Debtor and Defendant, and that forward contracts necessarily constitute 'swap agreements' when in fact, the contractual arrangement at issue here is nothing more than a series of agreements between a supplier and an end user for the purchase of a commodity to be delivered at an agreed upon price in the future."

The trustee submitted an expert report contending that "no market would recognize the [NAESB] contract between the parties in the present case as a swap."

The distinction between forward contracts for physical use of natural gas and swap agreements is critical because the protections afforded parties to forward contracts by section 546(e) are more limited than the protections afforded parties to swap agreements by section 546(g). Under the latter, all

payments to a swap participant are protected, but only margin or settlement payments are protected for forward contracts.

The court characterized the NAESB contract as a "simple supply contract for the sale of natural gas by one party, National Gas, to another, Smithfield."

The trustee (in opposing Smithfield's efforts to stay discovery pending appeal) characterized Smithfield's argument as contending that the Bankruptcy Code, as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), "now contains a bright-line rule that any agreement for the sale of a commodity to be delivered more than days after the date of the agreement is a 'swap agreement' and protected from the trustee's power to avoid fraudulent transfers."

The trustee portrayed such an interpretation as "elevate[ing] every simple supply agreement involving the sale of a commodity on terms other than cash-and-carry to the level of a financial derivative protected from avoidance action."

In siding with the trustee's argument that the NAESB contract, although a forward contract, was not a forward agreement, the court also cited confusing language in the definition of forward contract:

"To complicate things further, the definition of forward contract excludes a 'commodity contract.' § 101(25). All parties agree that natural gas is a commodity. The term commodity contract is not defined and could reasonably be interpreted to mean a contract involving a commodity to be delivered in the future, but one that is not 'the subject of dealing in the forward contract trade.' For both of these reasons, the court believes that a simply supply contract should not be included within the definition of a forward contract."

In characterizing the NAESB contract as a simple supply contract for physical gas, National Gas rejected the U.S. Court of Appeals for the Fifth Circuit's decision in Williams v. Morgan Stanley Capital Group Inc. (In re Olympic Natural Gas Co.) and the bankruptcy court's decision in In re Mirant Corp.

The contract in Olympic Natural Gas was a "Natural Gas Sales and Purchase Contract," which provided that "each month the parties would enter into a series of individual transactions, in which each would act sometimes as buyer and sometimes as seller, after agreeing the price, quantity, timing, and delivery point or the natural gas."

One of the parties to the contract, Morgan Stanley Capital Group, was not a supplier of natural gas but acted as both buyer and seller under the contract. The contract in that case clearly was not an actual supply contract.

Oympic Natural Gas and Mirant both found a basis not to construe "forward contract" as excluding "commodity contracts" and still preserve the safe harbor provisions for the agreements at issue. But National Gas concluded

that those courts were wrong based on a "plain meaning" read of Code Section 101(25), which at that time did not yet specify that the term "commodity contract," as used in the definition of "forward contract," has the meaning prescribed by Code Section 761(4).

National Gas sought to justify its decision with "textualism" by cloaking the result in the equality of treatment for like creditors principle underlying the Code:

"The court's conclusion that the contract at issue is not within the definition of a swap agreement also comports with an important guiding principle for all bankruptcy courts, which was recently emphasized by the United States Supreme Court in Howard Delivery, 126 S.Ct. at 2109. The Court stated that 'the Bankruptcy Code aims, in the main, to secure equal distribution among creditors.' In that case, the Court concluded that it was 'far from clear' that an employer's liability to provide worker's compensation coverage came within the language of § 507(a)(5), which confers priority for contributions to an employee benefit plan arising from services rendered. 126 S.Ct. at 2116. For that reason, and because other factors also weighed against that categorization, the Court determined that 'any doubt concerning the appropriate characterization ... is best resolved in accord with the Bankruptcy Code's equal distribution aim.' 126 S.Ct. at 2116. Affording to the trustee the full range of his statutory avoidance powers, on the facts before the court, is in line with both the Code's goal of equal distribution and 'the complementary principle that preferential treatment of a class of creditors is in order only when clearly authorized by Congress.'" 126 S.Ct. at 2109.

Critically, National Gas limited the applicability of its ruling to bankruptcy petitions filed prior to the effectiveness of the 2006 amendments to the Code contained in the Financial Netting Improvement Act of 2006. Those amendments revised the Code to clarify that the term "commodity contract" in the definition of "forward contract" has the meaning given in Section 761(4):

"[T]he fact remains that Congress did not refer to § 761(4) either in 1990 or in 2005 when the definition of 'forward contract' was amended by BAPCPA. Section 101(25)(A) was amended by the Financial Netting Improvements Act of 2006, Pub.L. 109-390, § 5(a)(1)(C)(i), and now provides that 'commodity contract' is defined in § 761. The 2006 amendment is not applicable in this case, because the case was filed prior to the amendment's effective date of December 12, 2006."

Given the current state of the Code and the bankruptcy judge's affirmative restriction of his decision to the contract at hand, the significance of this decision should be limited.

Nevertheless, National Gas raises significant concerns for parties — especially end users and producers — whose counterparties are in bankruptcy proceedings not governed by the 2006 revisions.

Not only is the risk of avoidance actions greater under National Gas, but the

ability of a party to a NAESB contract to walk away from a bankrupt counterparty could be in doubt.

Considering the import of this decision, on Sept. 12, 2007, Smithfield was granted leave to pursue an appeal directly to the U.S. Court of Appeals for the Fourth Circuit in Richmond, Va.

In the meantime, skirmishes continue before the lower courts about whether to allow discovery and pretrial matters, the results of which could prejudice the appeal. It is important for the Court of Appeals to address this issue. And a prompt decision on that appeal will hopefully assuage concerns about the lingering uncertainty.

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