

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).

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.

² 294 F.3d 737 (5th Cir. 2002)

³ 310 B.R. 548 (2004)

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