Fourth Circuit Reverses Bankruptcy Court's Narrow Reading of "Swap Agreements"

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The Fourth Circuit's reversal of the bankruptcy court's narrow reading of swap agreement clarifies the nature of agreements entitled to broad protections under the Bankruptcy Code, but until the decision is fully implemented on remand, swap participants will bear increased risk in hedging transactions.

On February 11, 2009, the U.S. Court of Appeals for the Fourth Circuit, in *Richard M. Hutson, II, Trustee for National Gas Distributors, LLC v. E.I. du Pont de Nemours and Co., Inc., Smithfield Packing Co., Inc., f/k/a Stadlers Country Hams, Inc.* (*In re National Gas Distributors, LLC*), reversed a decision on direct appeal from the U.S. Bankruptcy Court for the Eastern District of North Carolina (Judge Small presiding), which gave an improperly narrow reading to the definition of a "commodity forward agreement" and remanded for a finding, in light of certain required elements found in the statutory language, of whether the contract at issue was a commodity forward agreement entitled to broad protections under the Bankruptcy Code.

Background

On December 16, 2006, the trustee in the Chapter 11 bankruptcy of National Gas Distributors, LLC (NGD), a distributor of natural gas to industrial, governmental and other customers, commenced adversary proceedings against the defendants seeking to avoid numerous gas supply contracts entered into with these customers during the year before NGD filed its bankruptcy petition. The trustee alleged that the contracts and transfers of natural gas were fraudulent conveyances because they were made for less than market value, when NGD was insolvent.

The defendants moved to dismiss the complaints on the basis that the contracts at issue were "swap agreements" and, as such, were entitled to a complete defense under the Bankruptcy Code. Specifically, the defendants alleged that the agreements were "commodity forward agreements," which are included in the definition of "swap agreements" under the Bankruptcy Code. As swap agreements, they are exempt from the automatic stay and most avoidance actions. The bankruptcy court denied the motions to dismiss holding that the undertakings were simple supply agreements by a single end user to purchase a commodity, which were physically settled and not traded in the financial markets. As such, according to the bankruptcy court, the agreements did not qualify as swap agreements. The defendants appealed the decision directly to the Fourth Circuit. BP Energy Co., Inc.; the ISDA, Inc.; and First Citizens Bank & Trust Co. filed *amicus* briefs in support of the defendants.

The Contracts

The contracts at issue consisted of the NAESB "Base Contract for Sale and Purchase of Natural Gas" and a series of e-mails confirming telephone conversations between representatives of the parties in which they fixed the price of future deliveries of natural gas during specified time periods. Performance of the contracts formed in this way always commenced more than two days after the contract's formation and fixed the price of gas for a period of months for each designated facility. The contracts required NGD to sell and deliver the gas, and the customer to purchase and receive the gas at the specified fixed price, regardless of the market price of natural gas, or to pay the difference between the agreed-upon price and the market price. Although the contracts were not transferred on exchanges, the contracts provided the customers with a hedge against price fluctuations, thereby allowing them to manage their commodity risks.

The Bankruptcy Court Decision

The bankruptcy court examined the defendants' natural gas supply contracts at issue and concluded that they were not "commodity forward agreements." The court's conclusion was based on the legislative history and construction of the definition of "swap agreement" in section 101(53B) of the Bankruptcy Code. The court held that the contracts were insufficiently tied to financial markets to be commodity forward agreements. In the bankruptcy court's view, the legislative history made clear that Congress intended to exclude true swap agreements from the automatic stay and avoidance provisions in order to protect the financial markets from the destabilizing effects of a bankruptcy proceeding. Therefore, that court found a commodity forward agreement must be "regularly the subject of trading" in financial markets and must be settled by financial exchanges of the differences in commodity prices. The defendants' contracts, however, were settled directly between the contract parties and contemplated physical delivery of the commodity (natural gas) to the purchasers. Therefore, in the eyes of the bankruptcy court, such contracts were "not in that league" of agreements defined as "swap agreements."

The Fourth Circuit Decision

Taking advantage of the direct appeal process established by the 2005 amendments, the case went directly to the Fourth Circuit based on the significance of the issues on appeal. Although the Fourth Circuit agreed that Congress sought to provide safe harbors to protect the financial markets from the destabilizing effects of a bankruptcy case, it held that the term "swap agreement" was defined too narrowly by the bankruptcy court, there was no statutory requirement that a commodity forward agreement be traded on an exchange or in a market, and there was no statutory requirement that a swap agreement be settled financially. Further, given the absence of clear interpretive authority, it set out statutory guideposts to assist judges in recognizing commodity forward agreements and swap agreements.

"Swap Agreement" Given Broad Meaning

The term "swap agreement" is given broad meaning under the Bankruptcy Code. Since the enactment of the 1978 Bankruptcy Code, Congress has provided safe harbor for parties to specified commodities and financial contracts. By 2005, Congress had "substantially expanded the protections it had given to financial derivative participants and transactions by expanding the definition of 'swap participants' and 'swap agreements.'" The Fourth Circuit noted that "current definition of 'swap agreement' is now extremely broad, covering several dozen enumerated contracts and transactions, as well as combinations of them, options on them, and similar contracts or transactions." However, most of the transactions, including “commodity forward agreements,” are not defined in the Bankruptcy Code. Therefore, courts must rely on normal principles of statutory interpretation, including dictionary definitions and legislative history.

No Requirement That Agreement Be Traded on Exchange

The Fourth Circuit rejected the bankruptcy court’s assumption that all agreements addressed in section 101(53B) must be traded on an exchange or in a financial market. The Fourth Circuit carefully parsed the governing statutory provisions, legislative history and Chicago Mercantile Exchange definitions of terms such as “agreement,” “contract,” “forward contract” and “future contract.” The Fourth Circuit concluded that Congress did not intend to require that forward contracts be traded on an exchange. Moreover, it observed that other courts have found no such requirement. Accordingly, the Fourth Circuit rejected the bankruptcy court’s assumption that all of the agreements covered by section 101(53B) must be traded in the financial markets.

Further, the Fourth Circuit concluded that the bankruptcy court’s assumption that the contracts at issue were “simple supply contracts” was an “oversimplification.” First, the Fourth Circuit observed the agreements were part of a series of contracts by which the customers hedged their risk of future fluctuations in the price of gas. Although these particular contracts were not traded in financial markets—and perhaps were not even assignable—they nonetheless could have an influence on markets in which participants enter into hedging agreements. Accordingly, a simple forward supply contract can readily be tied into the broader markets that Congress aimed to protect when it modified the Bankruptcy Code in 2005.

No Requirement That Agreement Be Settled Financially

The Fourth Circuit rejected the bankruptcy court’s conclusion that agreements which are physically settled do not fall within the agreements described in section 101(53B). The Fourth Circuit concluded that nothing in the Bankruptcy Code or in the legislative history suggests a requirement that a forward agreement cannot involve a physical settlement. Further, numerous courts have found that forward contracts can be physically settled. Accordingly, Congress did not preclude physical delivery in connection with a commodity forward agreement.

Non-Exclusive Elements That Statute Appears to Require

Rather than conclude as a matter of law that the trustee’s claims failed, the Fourth Circuit remanded to the bankruptcy court for a determination of whether the contracts at issue are commodity forward agreements or swap agreements. In so doing, the Fourth Circuit acknowledged that the bankruptcy court did not enjoy the benefit of developed case law or clear market definitions, and , therefore, the Fourth Circuit provided the bankruptcy court with certain non-exclusive elements that the Bankruptcy Code appears to require.

First, the subject of a commodity forward agreement must be a commodity. Second, the contract must require a payment for the commodity at a price agreed upon at the time of contracting for delivery more than two days after the contract is entered into. Third, the quantity and time element must be agreed upon at the time of contracting. Finally, although swap agreements include contracts that are readily assignable and therefore tradable, they also include forward contracts which are not necessarily assignable.

Conclusion

The Fourth Circuit's reversal and remand, accompanied by the guidance it gave to lower courts, appears aimed at providing the bankruptcy court the guidance necessary to grant the motions to dismiss based on the Chapter 5 safe harbor provisions (*i.e.*, that the defendants' contracts are as a matter of law swap agreements excepted from the automatic stay and avoidance powers). The decision is significant to swap participants because it rejects a narrow reading of "swap agreement" and because it provides significant guidance regarding the key elements a court must look for when analyzing whether an agreement falls within the definition of "commodity forward agreements." Still, it appears that the Fourth Circuit could have ruled on the agreements before it, but chose not to. Instead, the Fourth Circuit remanded and left "further legal and factual development" for the bankruptcy court. If the bankruptcy court interprets this to mean that it must deny the motion to dismiss pending a full development of the facts, the efficacy of the Chapter 5 safe harbors will be significantly diluted notwithstanding the otherwise favorable interpretation announced by the Fourth Circuit. Those safe harbor provisions are intended to allow close-out and netting—without threat of any liability under the avoidance powers of Bankruptcy Code Chapter 5. The threat of litigation by bankruptcy trustees, especially if the matter survives a motion to dismiss, will continue to cloud hedging transactions and diminish liquidity. Accordingly, despite the positive aspects of the ruling, until this decision is fully implemented on remand, swap participants will bear increased risk on hedging transactions.