

Appeals Court Affirms Safe Harbor for Forward Contracts in Bankruptcy

Anthony Michael Sabino

Recent events have only painfully confirmed what we already knew. A bankruptcy filing by a major corporation can have calamitous consequences for numerous parties, including, among others, counterparties to ongoing contracts with the now-insolvent entity. For the vast majority of businesses so afflicted, there is nothing they can do but wait out the tortuous Chapter 11 process. Even under the somewhat accelerated timetable brought about by the 2005 amendments to the Bankruptcy Code, this process is still expensive, time-consuming, and arduous.

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Notwithstanding those realities, there have been special groups of creditors that have fared somewhat better. For purposes of this audience, most prominent of those have been the counterparties to specific categories of financial instruments, widely character-

ized as “derivatives,” “swaps,” and “commodity forward contracts,” just to name a few. In order to preserve the free flow of the marketplace, Congress years ago carved out a special status for such instruments, permitting them to progress toward completion, unfettered by the restraints of nominal bankruptcy law.

Federal appeals court has . . . made the “safe harbor” truly safe once again.

This, then, is the “safe harbor” for exotic financial instruments, a placid sanctuary first created, then nurtured, by lawmakers for decades. Nevertheless, recently the tranquility of the safe harbor was storm-tossed by a bankruptcy judge’s opinion that overturned the entire regime and threatened the stability of energy industry contracts at a most inopportune time. But now, a federal appeals court has reversed that lower court’s holding and made the “safe harbor” truly safe once again. That timely and vital decision is the subject of this article.

TRUSTEE SAYS THAT FORWARD AGREEMENTS ARE FRAUDULENT

The case is titled *Hutson v. E.I. Du Pont De Nemours and Co., Inc. (In re National Gas Distributors, LLC)*.¹ It arose from the Chapter 11 of National Gas Distributors (NatGas), a prominent energy industry player. As its name suggests, the entity is primarily in the business of distributing natural gas to industrial customers. Among those corporate clients were chemical giant Du Pont and Smithfield

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Packing Company (purveyors of Virginia's famous Smithfield hams). Needless to say, these large industrial concerns consumed a vast amount of natural gas as part of their normal operations, so their contractual relationship to NatGas was significant.

During the year prior to NatGas's Chapter 11 filing, Du Pont, Smithfield, and others entered into contracts calling for NatGas to make future deliveries of natural gas at fixed prices, deliveries called "forward agreements." The purpose of these contracts was to lock in supplies regardless of market prices, and thus hedge against fluctuations in the natural gas market. The parties negotiated the contracts themselves, did not involve brokers or middlemen, and did not trade them on any exchange. Significantly, the court noted, "the customers did use [forward agreements], along with other forwards and derivatives, to manage their commodity risks."

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After the debtor entered into reorganization, the bankruptcy judge appointed Hutson as trustee to manage its affairs. Thereafter, Hutson commenced litigation against these customers, demanding over \$4 million in damages that supposedly represented the difference between what the customers paid for gas under the forward contracts and the then-higher market price of the natural gas supplied. The trustee's lawsuits were based upon the legal theory of a "fraudulent conveyance" (i.e., when a debtors' property is conveyed to a third party for less than fair market value, the transfer is fraudulent because it was for less than fair consideration). Section 548 of the Bankruptcy Code permits trustees and debtors-in-possession (a reorganizing debtor that keeps operating without a trustee) to recover such "fraudulent conveyances" from the third party. The theory is that recovery of the value of the misappropriated asset permits the debtor to reorganize or

otherwise have more money available for an equal distribution to all creditors.

When a debtors' property is conveyed to a third party for less than fair market value, the transfer is fraudulent.

BENEFICIARIES SAY THESE ARE VALID SWAP AGREEMENTS; BANKRUPTCY JUDGE DISAGREES

Not surprisingly, Du Pont, Smithfield, and the other defendants opposed on legal grounds. The gist of their argument was that these natural gas supply contracts were "swap agreements," as defined by law, and were immune from an "avoidance action" (i.e., being unraveled by a trustee). This safe harbor was provided for in the Bankruptcy Code since its inception in 1978 and can be found in Section 546 of the law. By definition, they argued, the "swap agreements" at issue here were "commodity forward agreements," as set forth elsewhere in the definitional provisions of the federal insolvency law. Moreover, the customers asserted that they received their supplies in good faith and offered that as yet another reason to dismiss the trustee's claims as legally deficient.

The bankruptcy court disagreed with the customers. In its interpretation of Section 546's legislative history, the court determined that the natural gas supply contracts here were "insufficiently tied to financial markets to be commodity forward agreements." Indeed, that judge ruled that commodity forward agreements, in order to enjoy refuge in Section 546's safe harbor, need to be "regularly the subject of trading" in financial markets, and subject to monetary settlement on recognized financial exchanges.

The court determined that the natural gas supply contracts here were "insufficiently tied to financial markets to be commodity forward agreements."

Here, the bankruptcy judge opined, these contracts were directly negotiated and contem-

plated actual physical delivery of the goods, and thus the contracts could never be defined as true commodity forward agreements. Consequently, they could never be protected by statute. In point of fact, in a later, supplemental ruling, the bankruptcy judge called the agreements “simple supply contract[s].”

But the controversy did not end there.

STRAIGHT TO THE COURT OF APPEALS WITHOUT STOPPING BY DISTRICT COURTS

Normally, the decision of a bankruptcy judge is appealed first to a federal district judge. This route is followed because bankruptcy judges, appointed per Article I of the U.S. Constitution, are a subunit of the far more powerful Article III district court, whose judges are appointed for life and may properly exercise the full scope of federal judicial power. However, because this question was deemed to be so imperative to both these parties and the financial markets as a whole, the case skipped the district court and was directly appealed to the U.S. Circuit Court of Appeals for the Fourth Circuit (likewise, of course, composed of all Article III judges).

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Circuit Judge Niemeyer commenced the tribunal’s opinion with a review of the fundamental reasons behind the statutory scheme at issue here saying, “Since enactment of the 1978 Bankruptcy Code, Congress has provided safe harbors from the destabilizing effects of bankruptcy proceedings for parties to specified commodities and financial contracts in order to protect financial markets.” To that end, the lawmakers exempted parties to such transactions from nominal Code restraints, such as the statutory automatic stay, and, pertinent here, the legal device of the avoidance of fraudulent conveyances.

The *NatGas* panel then gave an elaborate (but useful) dissertation on Congress’s ratio-

nale in this regard. Quoting various legislative sources and learned commentary, Judge Niemeyer summarized the legislature’s great concern for protecting the over-the-counter markets for financial derivatives, ensuring systemic liquidity, and doing everything possible to avoid a market collapse brought about by a bankruptcy “freeze-up” of these widely traded instruments.² Congress was explicit in recognizing the volatility of these markets and stating its strong wish to provide a safe harbor amid that turbulence. The original protections afforded by the 1978 enactment were expanded by further promulgations over the years, implicitly to expand, not diminish, the intended safe harbor.

With that in mind, the Fourth Circuit went on to observe that the latest round of alterations to the nation’s bankruptcy law, made in 2005, “substantially expanded the protections [Congress] had given to financial derivatives participants and transactions by expanding the definition of ‘swap agreements’ and ‘swap agreements’ that are exempted from . . . trustees’ avoidance powers.” The legislative history cited by the appeals court confirmed that the lawmakers wanted to update the statutory definition (ostensibly to make it current with modern financial practice) and achieve contractual stability across economically similar transactions. For these reasons, the current categorizations in the safe harbor proviso are “now *extremely* broad, covering several dozen enumerated contracts and transactions, as well as combinations of them, options on them, and similar contracts or transactions (emphasis supplied).” Finally, said the tribunal, the law “now protects all counterparties to these agreements (emphasis in the original).”

Legislative history cited by the appeals court confirmed that the lawmakers wanted to . . . achieve contractual stability across economically similar transactions.

Turning to apply these findings to the matter at hand, the panel regarded the customers’ basic argument as claiming their natural gas

supply agreements were “swap agreements,” which in turn were “commodity forward agreements” protected by statute. However, the nub of the problem was that the Bankruptcy Code neglects to define “commodity forward agreement.” More significant, no earlier case had endeavored to do so. That made this case one of first impression, and the Fourth Circuit, writing on a clean slate, moved forward to make law.

“If one were to assume,” as the bankruptcy judge did, “that trading on a financial exchange was an absolute prerequisite to recognition as a bankruptcy-proof contract, then the arrangements at issue here could be correctly classified as mere supply contracts.” But in a revealing turn of events, the Fourth Circuit declared, “The assumptions, however, do not withstand closer scrutiny.”

The defining provisos of the Bankruptcy Code do not require that forward contracts “be traded on an exchange or in a market.”

In recent years, Congress had made technical changes to the statutory language that parsed out commodity contracts from purely forward contracts. In enacting such, the accompanying legislative history made it apparent to this appeals court that the lawmakers did not intend that forward contracts need be traded “on any exchange or in any financial market” in order to qualify for special treatment. The defining provisos of the Bankruptcy Code do not require that forward contracts “be traded on an exchange or in a market.”

Similarly, courts in a nonbankruptcy context have held that forward agreements, such as those at issue here, include “directly negotiated . . . non-market traded, private agreements.” Finally, *Black’s Law Dictionary* itself distinguishes futures contracts as instruments that must be traded on a formal exchange, whereas forward contracts have no such requirement.

“The weight of authority thus indicates,” wrote Judge Niemeyer, that forward contracts simply are not found on the trading floors

of the financial exchanges. Quite to the contrary, they remain private arrangements between particular parties and they are directly negotiated, as opposed to being bought and sold in an open marketplace. In this fashion, the tribunal overturned the first key assumption of the bankruptcy court and held that trading in a recognized market is not necessary to afford the Section 546 safe harbor to a forward contract.

In like fashion, the Fourth Circuit moved on to debunk another erroneous assumption made by the bankruptcy judge. This was the notion that the NatGas deals were simply supply contracts, and therefore could never be determined to be exempt forward agreements. “But this assumption is an oversimplification,” decried the bench.

Certainly, the product delivered was a supply of natural gas. In this tribunal’s opinion, it was far more significant that the underlying arrangements “were part of a series of contracts by which the customers hedged their risk of future fluctuations in the price of natural gas.” The court made the cogent point that these deals, while admittedly not traded in an open market (and possibly not even assignable to third parties), “nonetheless could have an influence on markets in which participants enter into hedging agreements.”

Judge Niemeyer took care to paint the scenario where one such forward agreement leads to another, and another, and another. “And so a simple forward agreement may readily become tied into the broader markets that Congress aimed to protect” in the special provisions of Section 546. This linkage, decreed the court, is enough to provide sanctuary for the contract at issue.

Notably, the Fourth Circuit analogized the situation before it to one previously decided by its august sister tribunal, the Seventh Circuit, in *Nagel v. ADM Investor Services, Inc.*³ It concerned farmers entering into forward contracts with grain merchants who, in reliance thereupon, entered into futures contracts traded on the established commodities markets. The common element, of course, is that private arrangements not traded on a recognized exchange in turn provided the impetus for subsequent hedging agreements in

active financial markets. Applying that wisdom to *NatGas*, the Fourth Circuit found the customers before it in the same place, because they, like the farmers, entered into these arrangements as part of a larger hedging and risk management program that was most certainly intertwined with the national financial exchanges.

Finally, the appellate court turned to refute the last presumption of the bankruptcy judge, that the agreements here could never sail into the safe harbor of Section 546 because they did indeed call for the actual physical delivery of natural gas. The bankruptcy court contended that the lack of an element of a financial “settlement” (i.e., a cash transfer) disqualified these deals from exempt treatment under the Bankruptcy Code. Put another way, a contract that called for a real physical delivery could never qualify for the statutory exemption.

That view is erroneous, wrote Judge Niemeyer, because it ignored the fact that, while the obligations of the parties centered primarily upon actual physical delivery of natural gas, these contracts “contained real hedging elements,” including liability to pay the difference between the contract price and the market price in the event either party did not perform as specified. This implicit monetary corollary made the deal more than a simple supply contract, said the appeals court.

Furthermore, the panel found nothing in the Bankruptcy Code that ousted forward agreements from special treatment simply because they called for the actual delivery of the underlying commodity. According to this court, nothing that Congress wrote into statute operates to bar a particular contract from the benefit of Section 546’s special protections simply because it in the first instance calls for physical delivery of a product.

Now the Fourth Circuit took its final, and important, procedural step. Because the bankruptcy judge had viewed the controversy through the prism of a too-narrow interpretation of the statute, the case was sent back for reexamination, to be made in light of the tribunal’s ruling. In doing so, the panel noted that Congress has not always been crystal clear in articulating its true intentions, and

that lack of clarity is exacerbated because the financial marketplace is “creative, designing instruments to fit the needs of the moment” without heed to the law that might someday impact the status of certain of these arrangements.

FOURTH CIRCUIT PROVIDES GUIDELINES

The Fourth Circuit reminds that the policies of the Bankruptcy Code are often in painful counterpoise. On one hand, the lawmakers wish to assure equality of distribution among creditors of bankrupt entities. Thus, financial counterparties need to share the pain. At the same time, Congress had long had “a countervailing policy of protecting financial markets and therefore favoring an entire class of instruments and participants” by exempting them from bankruptcy’s normal strictures. Against this difficult backdrop, the tribunal attempted to give some guidance to the bankruptcy judge when revisiting the case. Careful not to actually prescribe a definition (leaving that to the lower court for an intense factual analysis), the Fourth Circuit did set out certain parameters to be followed.

First, a commodity forward agreement must, at base, include a commodity. This is not as obvious as it first sounds, because the panel noted that supply contracts are recognized by cost factors measured by things such as packaging, delivery, marketing, and so forth. In sharp contrast, forward agreements attribute price to the benefits or detriments in future fluctuations in commodity prices, as independently determined by the market itself.

Second, the “forward” nature of the agreement must be explicit. The arrangement must mature in the future at a price once again determined by market forces. This portion recognizes again the benefits or detriments to be harvested from entering into such transactions, with the full extent of the consequences to be determined.

Third, quantity and time are other characteristics of a true commodity forward agreement. These parameters need to be fixed at the moment the contract is entered into; thus, it cements the parties’ obligations to each other

at a certain time. Finally, the court noted that assignability is not a requirement to qualify as a bankruptcy-exempt forward agreement.

In closing, the Fourth Circuit again expressed the key axiom that Congress afforded significant protections for the financial markets from the disrupting effects of bankruptcy by inaugurating the exemptions of Section 546. But that causal link “need not be defined by trading in a market or on an exchange, as we have shown.” In stating that conclusion, the appellate court disabused any notion that, in order to qualify for the statutory exemption, a specific contract must be traded on a recognized exchange.

With all that being said, the Fourth Circuit concluded by explicitly not arriving at an absolute definition but returned the matter to the bankruptcy court with specific instructions as to erroneous assumptions to be avoided. Far more important, the panel imparted key wisdom to guide the bankruptcy judge in rendering a future and conclusive judgment on this issue.

DECISION STOPS WHAT COULD HAVE BEEN A MAJOR PROBLEM

In overviews of *NatGas* and what it means for the energy industry, we can first breathe a big sigh of relief. For many years, industry players have carefully structured forward contracts, swaps, and financial instruments du jour to assure themselves of the safe harbor of statutory exemption from the hurdles of the routine bankruptcy process. The lower court decision here cast an ominous dark cloud over the entire marketplace, but now that cloud has been lifted by the Fourth Circuit’s clarifying decision.

To be sure, the tribunal has sent the controversy back to that same bankruptcy judge for further fact finding and a fresh decision. But now the resolution of that matter will be guided by the appellate court’s wisdom. That guidance includes firm rulings that Section 546 still affords protection even to wholly private arrangements not traded on a recognized exchange, that actual physical delivery of the commodity is not a bar to statutory protection, and that mere implicit financial consequences to the parties are sufficient to label

such transactions as exempt financial instruments. Notably, the court took into account that even the recent 2005 amendments to the Bankruptcy Code expanded the protections Congress first envisioned over three decades ago, a clear indication that the lawmakers are resolved to maintain the safe harbor.

The mere implicit financial consequences to the parties are sufficient to label such transactions as exempt financial instruments.

In all, the Fourth Circuit’s decision pays appropriate deference to congressional intent to prevent upheaval in the financial markets, a task not easily accomplished because the statute is complex and its “plain meaning” not easily ascertained. But still the tribunal’s ruling takes into account that the law is, by necessity, intricate, and, moreover, the financial markets it protects continually engender even more complex instruments. In sum, this court recognizes there is a safe harbor, and that Congress intended it to be a welcoming destination for a variety of existing and yet-to-be-invented financial arrangements.

The aftermath of the Fourth Circuit’s decision in *NatGas* will undoubtedly be closely watched by the energy industry, albeit with a restored level of comfort. However, one can never underestimate how closely the entire financial community will monitor these proceedings, because we must consider *NatGas* against the much bigger picture of the Lehman Brothers bankruptcy and related financial insolvencies. Those cases and the parties involved are far more dependent upon the proper recognition of the safe harbor at issue in this energy industry case, and therefore expect *NatGas* to be a bellwether for these titanic cases that impact the entire economy. ☐

NOTES

1. ____ F.3d ____ (4th Cir. February 11, 2009) (No. 07-2105), available at www.ca4.uscourts.gov.
2. See Morrison, E. R., & Riegel, J. (2005). Financial contracts and the new bankruptcy code: Insulating markets from bankrupt debtors and bankruptcy judges. *American Bankruptcy Institute Law Review*, 12, 641–642.
3. 217 F.3d 436, 438–39 (7th Cir. 2000).