SUTHERLAND

LEGAL ALERT

August 14, 2007

Court Determines Commodity Supply Contract Is Not Swap Agreement Under Bankruptcy Code

A recent decision out of a North Carolina bankruptcy court has reopened the question of whether a physical supply contract may qualify as a forward contract or swap agreement for purposes of the Bankruptcy Code. Although previous U.S. case law determined that those terms included commodity supply agreements, the U.S. Bankruptcy Court for the Eastern District of North Carolina disagreed. Its ruling – that a simple supply contract between a natural gas seller and an end user does not constitute a swap agreement (while declining to determine whether the contract qualified as a forward contract, but expressing doubt on that issue) – could lead to significant complications for energy traders. If adopted elsewhere, the result could restrict access to the Bankruptcy Code's safe-harbor provisions for parties trading physical and financial energy products. Without safe-harbor rights, such parties may not be able to close out or offset transactions after a counterparty bankruptcy without first seeking court approval.

National Gas Distributors, LLC ("National Gas") was a small natural gas supplier that filed for bankruptcy protection in January 2006. The court appointed a chapter 11 trustee early in the case. The trustee proceeded to file fraudulent conveyance complaints against a number of customers, alleging that National Gas sold gas at below market prices, either as part of a fraudulent scheme or in a constructively fraudulent manner. Among the defendants in the fraudulent conveyance actions were several end users of gas, including Smithfield Packing Company ("Smithfield").

In its answer to the complaint, Smithfield asserted several defenses that required the underlying contract to be a swap agreement and required the parties to be swap participants. It is interesting to note that Smithfield did not assert the similar defenses available to forward contract merchants with respect to forward contracts. Smithfield filed a motion to dismiss the complaint, based on the Bankruptcy Code's safe-harbor provisions pertaining to swaps. The leading global financial trade association, the International Swap Dealers Association, Inc. ("ISDA"), filed an amicus curiae brief in support of Smithfield's motion to dismiss. In its brief, ISDA argued that a ruling in favor of the trustee would undermine existing legislation and Congressional intent.

The court looked first to the Bankruptcy Code for the definitions of "swap agreement" and "swap participant." The definition for "swap agreement" primarily consists of a series of examples of types of contracts that qualify as swap agreements. The relevant portion of the definition reads: "The term 'swap agreement' … means … any agreement … which is … a commodity index or a commodity swap, option, future, or forward agreement." (emphasis added) The definition for "swap participant" is more straightforward, defining the term to mean any entity "that, at any time before the filing of the petition, has an outstanding swap agreement with the debtor." Smithfield would qualify as a swap participant only if its contract (the "Contract") with National Gas constituted a swap agreement.

The Contract was a Base Contract for Sale and Purchase of Natural Gas, derived from a form agreement created by the North American Energy Standards Board. The Contract provided for National Gas to sell natural gas to Smithfield. Among the provisions of the Contract was the acknowledgement of the parties that the Contract constituted a "forward contract" for purposes of the Bankruptcy Code.

© Sutherland 2007. All Rights Reserved.
This communication is for general informational purposes only and is not intended to constitute legal advice or a recommended course of action in any given situation. This communication is not intended to be, and should not be, relied upon by the recipient in making decisions of a legal nature with respect to the issues discussed herein. The recipient is encouraged to consult independent counsel before making any decisions or taking any action concerning the matters in this communication. This communication does not create an attorney-client relationship between Sutherland and the recipient.

Likewise, the trustee acknowledged that the Contract was a forward contract involving a commodity. He argued, however, that a *forward contract* is not the same as a *forward agreement*, as the latter term is used in the above definition of swap agreement. Because the Contract was not a forward agreement or any other type of contract explicitly listed in the definition of swap agreement, the trustee contended that the Contract was not a swap agreement.

Despite the trustee's concession, the bankruptcy court declined to accept that the Contract was a forward contract. It included a lengthy discussion suggesting that the Contract was not a forward contract and that supply contracts must be regarded as simple "commodity contracts," which are differentiated from forward contracts in the Bankruptcy Code. Ultimately, though, the court opined that the forward contract issue was not dispositive and therefore chose not to reach any conclusion on whether the Contract constituted a forward contract.

The bankruptcy court then determined that the Contract should not be given the protections offered to swap agreements, because Congress intended such protections to assist only financial markets, whereas the Contract was a physical, supply-oriented agreement. Therefore, the court held that the definition of swap agreement does not include "contracts between a seller and an end user for delivery of a product that happens to be a recognized commodity."

In reaching that conclusion, the bankruptcy court acknowledged and disagreed with the non-binding precedent of *Olympic Natural Gas*, a 2002 case from the U.S. Court of Appeals for the Fifth Circuit. In *Olympic*, the Fifth Circuit concluded that a gas supply contract was a forward contract under the Bankruptcy Code definition. The *National Gas* bankruptcy court distinguished *Olympic* on the grounds that the seller in *Olympic* acted as both buyer and seller under the applicable agreement. Therefore, it opined, the agreement in *Olympic* was not a simple supply contract.

Based on the analysis discussed above, the bankruptcy court denied Smithfield's motion to dismiss the complaint. Smithfield has asked the court for permission to appeal the ruling to the district court, and ISDA has filed a brief in support of the appeal. If the bankruptcy court does not allow the appeal, the proceeding will advance to a full trial.

The *National Gas* opinion represents a troubling departure from the rule established under the *Olympic* case. *Olympic* (and a few Canadian cases on which it relied) set a reasonable and reliable standard, under which a physical supply contract qualified for the safe-harbor protections of the Bankruptcy Code. Subsequently, several lower courts followed and relied on the *Olympic* opinion – as did the marketplace. The *National Gas* departure from the *Olympic* line of cases will introduce uncertainty to market participants – all the more so if future courts choose to follow *National Gas*. In particular, the decision should concern both end users and counterparties who trade with end users who had assumed that they would be afforded safe-harbor protections in the event of a counterparty bankruptcy.

© 2007 Sutherland Asbill & Brennan LLP. All Rights Reserved.
This article is for informational purposes and is not intended to constitute legal advice.

SUTHERLAND

If you have any questions regarding this alert, or the services we provide, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

James M. Cain	202.383.0180	james.cain@sablaw.com
Warren N. Davis	202.383.0133	warren.davis@sablaw.com
Robin J. Powers	212.389.5067	robin.powers@sablaw.com
Peter H. Rodgers	202.383.0883	peter.rodgers@sablaw.com
Mark D. Sherrill	202.383.0360	mark.sherrill@sablaw.com
Paul B. Turner	713.470.6105	paul.turner@sablaw.com

© 2007 Sutherland Asbill & Brennan LLP. All Rights Reserved.
This article is for informational purposes and is not intended to constitute legal advice.