LJN LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist®

An ALM Publication

Volume 28, Number 7 • May 2011

Of Hogs, Electricity And Gas

Supply Contracts Under The Safe Harbor of Section 546

By Yitzhak Greenberg

A split among bankruptcy courts has called into question whether supply contracts for commodities such as hogs, electricity and gas will receive the same protection that has been extended to swaps and other financial contracts under § 546 of the Bankruptcy Code. That section provides a safe harbor to transfers made pursuant to financial contracts. The stability of these contracts is deemed so essential to the health of the nation's financial markets that they are broadly excepted from avoidance as preferences and fraudulent transfers. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") further clarified the broad intent and application of the safe harbor of § 546.

Businesses' ability to rely on § 546 to insulate their supply agreements (*i.e.*, contracts that do not specify an amount of the commodity) from the potentially disruptive effects of a bankruptcy filing by their counterparties has been called into question. Recently, two bankruptcy courts had the opportunity to apply BAPCPA to forward supply contracts and agreements and came to very different conclusions. In one line of decisions, the Louisiana Bankruptcy Court looked to

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Chemtura: 'Make-Whole' and 'No-Call' Provisions

By Edward E. Neiger and Marianna Udem

The Bankruptcy Court for the Southern District of New York's recent decision in *In re Chemtura Corp.*, 439 B.R. 561 (Bankr. S.D.N.Y. 2010) ("*Chemtura*") examines the treatment of "make-whole" and "no-call" provisions in bankruptcy proceedings in the context of a settlement of such claims pursuant to a plan or reorganization. Generally, a "no-call" provision prohibits the prepayment of debt prior to maturity while a "make-whole" provision acts as a liquidated damages clause and provides a mechanism for determining what amount a debtor must pay in order to prepay its debt prior to maturity. Ultimately approving the settlement without deciding on the enforceability of claims for "make-whole" amounts and damages for breach of "no-call" provisions, the *Chemtura* court conducted a thorough examination of recent case law and provided a detailed roadmap of the analysis it would conduct should the issues be litigated.

Background

The debtors, specialty chemicals company Chemtura Corporation and its affiliates, sought confirmation of their Chapter 11 plan, which included a global settlement among the debtors, the unsecured creditors committee and an ad hoc group of bondholders. The equity committee objected to confirmation of the plan and the proposed settlement. The debtors' liabilities included, among other things, bonds issued pursuant to two separate indentures. The first indenture (the "2016 Notes") included a "make-whole" provision, while the second indenture (the "2026 Notes") included a "no-call" provision. If allowed in full, the aggregate claims asserted pursuant to the respective "make-whole" and "no-call" provisions would total approximately $170 million. The debtors proposed to settle these claims by paying approximately 39% of the potential liability for breach of the "no-call" provision under the 2016 Notes and 42% of the potential liability for the "make-whole" provision under the 2026 Notes.

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The Court's Analysis

The court began its analysis by noting that the standard for approving the settlement did not require it to issue a decision on the merits of the enforceability of the "make-whole" and "no-call" provisions in bankruptcy. Nevertheless, the court provided a detailed analysis of the conflicting case law on the issues. The court noted that in addition to two conflicting decisions by bankruptcy courts within the Southern District of New York decided at the time the settlement was reached, *In re Calpine Corp.*, 365 B.R. 392 (Bankr. S.D.N.Y. 2007) ("*Calpine I*") and *In re Solutia*, 379 B.R. 473 (Bankr. S.D.N.Y. 2007 ("*Solutia*"), two more decisions of interest were issued, once again "one on each side of the controversy." These were *HSBC Bank, USA, N.A. v. Calpine Corp.* (*In re Calpine Corp.*), 2010 U.S. Dist. LEXIS 96792 (S.D.N.Y. Sept. 14, 2010) ("*Calpine II*") and *In re Premier Entm't Biloxi*, 2010 Bankr. LEXIS 2994 (Bankr. S.D. Miss. Sept. 3, 2010) ("*Premier Entertainment*"). *See Chemtura* at 599.

Calpine I

During the course of their Chapter 11 cases, Calpine Corporation and its affiliated debtors sought to refinance their debtor-in-possession financing and repay approximately $2.5 billion in secured debt of debtor CalGen. The CalGen secured debt was comprised of three tranches, two of which included "make-whole" provisions requiring premium payments if the debt was prepaid during the two years immediately preceding the maturity dates. All three tranches of secured debt included "no-call" prohibitions of early prepayment. The debtors sought authority to pre-pay all three tranches prior to maturity and prior to the effective dates of the "make-whole" provisions. At the outset, the court determined that the debt could be prepaid notwithstanding the "no-call" provisions, recognizing that specific performance of such provisions is unenforceable in bankruptcy cases. The court then examined whether the lenders were entitled to "make-whole" damages. The court found that because the loan documents did not explicitly require the payment of charges for "make-whole" claims resulting from repayment of the debt upon maturity caused by acceleration, the lenders were not entitled to secured claims as a result of such damages under § 506(b) of the Bankruptcy Code. However, the court held that the lenders would be entitled to unsecured claims for expectation damages. To calculate the resulting claims, the court concluded that the "make-whole" provisions contained in two of the tranches of the CalGen secured debt served as reasonable proxies for measures of damages.

Solutia

In *Solutia*, bondholders sought expectation damages for future interest income that they expected to receive under the indenture but for the breach of the "no-call" provisions. The court rejected the bondholders' claim and found that an acceleration clause in the indenture took effect, thus the notes were mature and a prepayment prior to maturity did not occur. The court also noted that the bond indenture lacked precise language calling for a "make-whole" payment upon an automatic acceleration. Finally, the

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The Bankruptcy Strategist®

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The Bankruptcy Strategist® (ISSN 0747-8917) is published by Law Journal Newsletters, a division of ALM. Telephone: (877) 256-2472
Editorial e-mail: wampolsk@alm.com
Circulation e-mail: customercare@alm.com
Reprints: www.almreprints.com

POSTMASTER: Send address changes to:
ALM
120 Broadway, New York, NY 10271

Published Monthly by:
Law Journal Newsletters
1617 JFK Boulevard, Suite 1750, Philadelphia, PA 19103
www.ljnonline.com

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Using § 552(a) to Invalidate a Lender's Security Interest in Proceeds of an FCC License

By Thomas F. Blakemore and Gregory A. Martin

Recently, a Colorado bankruptcy court considered the effects of Bankruptcy Code § 552(a) on a lender's security interest in the proceeds of an FCC broadcast license. The court held that a prepetition security interest would not extend to proceeds received from a post-petition transfer of the debtor's FCC license because the debtor did not have an attachable, prepetition property interest in the proceeds. Because a security interest does not extend to the underlying broadcast license, no interest in the proceeds of the license may arise until the FCC approves an agreement to sell the license. As no such sale was contemplated prepetition, § 552(a) prevented the lender's security interest from attaching the proceeds of a post-petition sale.

The Case

In *Spectrum Scan LLC v. Valley Bank and Trust Co.* (*In re Tracy Broadcasting Corp.*), 438 B.R. 323 (D. Colo. 2010), the debtor operated an FM radio station under a license issued by the FCC. Before filing for bankruptcy, the debtor granted a security interest in its general intangibles and related proceeds to its lender. Spectrum Scan, an FM radio station and unsecured creditor, filed an adversary complaint seeking determination of whether the lender's security interest in the debtor's general intangibles and proceeds extended to any proceeds realized from a sale of the debtor's FCC broadcast license. Neither Spectrum nor the lender argued that the bank held a security interest in the FCC license itself. The sole issue was whether the bank's interest in general intangibles extended to proceeds realized on the license in a post-petition sale.

Spectrum argued that: 1) if the bank did not have a security interest in the FCC license, it could not claim one in the license's proceeds; and, in the alternative, 2) even if the bank could obtain a security interest in the license, such interest would not attach until the debtor had the right to receive value for the license — since any sale of the license would occur post-petition, § 552(a) of the Bankruptcy Code would prevent the bank from acquiring an interest in the post-petition proceeds of the license.

In opposition, the bank argued that the FCC license may be bifurcated into public rights (defined as the power to determine who may become the licensee and the duration of the license) and private rights (defined as the licensee's interest in proceeds from an FCC-approved transfer of the license), and that the licensee could grant a security interest in its private rights. Moreover, the bank argued, the security interest in the private rights attached prepetition, when the security interest in general intangibles was granted, allowing the bank to recover post-petition proceeds under Bankruptcy Code § 552(b). A similar approach was adopted in *In re Media Properties, Inc.*, 311 B.R. 244 (Bankr. W.D. Wis. 2004). In that case, the court divided the FCC license into public and private rights, allowing for the prepetition attachment of a security interest in the private rights granted by the license. By taking this approach, Media Properties avoided application of § 552(a) by providing an avenue for the security interest to attach to the underlying broadcast license prepetition.

The Ruling

In reaching its holding, the *Tracy Broadcasting* court acknowledged the inconsistent holdings that preceded its decision. Some courts (including the Sixth and Seventh Circuits) have flatly held that no security interest may be granted in any aspect of an FCC license, while others (including the Ninth Circuit) have adopted the bank's position, that a security interest may be granted in the private rights granted by a license. It should be noted that only *Media Properties* dealt with the issue addressed here — the effects of § 552 on a security interest in the proceeds of a broadcast license.

Based on its study of case law on this point, the court "presume[d] that it is possible, at least in the absence of a bankruptcy, for a debtor to grant a security interest in its right to receive proceeds upon an FCC-approved transfer of its license." But the court rejected *Media Properties*, noting that "[t]he [d]ebtor's right to receive value for a transfer of its [l]icense did not exist prior to the filing of its Chapter 11 case because any such 'right' was too remote and was subject to two contingencies." According to the court, a security interest in the proceeds of an FCC license cannot attach until there is both a sale agreement and approval of the agreement by the FCC. In this case, neither of these contingencies had been satisfied prepetition. Thus, "the [d]ebtor did not have a sufficient property interest in this contingency in order to transfer a security interest in it to the [b]ank." If such a sale occurred after bankruptcy, Bankruptcy Code § 552(a) would prevent the bank's security agreement from attaching to the sale proceeds.

The Appeal

The *Tracy Broadcasting* decision is currently on appeal to the district court. The parties' positions have not changed — the bank maintains that Tracy acquired the right to sell the license (and grant a security interest in any proceeds resulting from such a sale) when Tracy obtained the license. While briefs have been filed, oral arguments have not yet been heard and no decision has been reached.

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Section 552(a)

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TERRESTAR NETWORKS

Another case, *In re Terrestar Networks, Inc. et al.*, pending before a bankruptcy court in the Southern District of New York, involves similar issues. In *Terrestar*, unsecured creditors have challenged Terrestar's grant of security interests in FCC broadcast licenses to its senior noteholders. In their summary judgment motions, the creditors argue that: 1) pre-petition liens on FCC licenses are invalid because there is no underlying property right in an FCC license; and 2) relying directly on *Tracy Broadcasting*, there can be no prepetition lien in proceeds of the licenses because no proceeds were available for attachment before the petition date. A hearing on the motions for summary judgment is scheduled for April 21, 2011.

CONCLUSION

Tracy Broadcasting Corp. is significant as it suggests, despite the existence of contrary authority in other Circuits, that the proceeds from the sale of an FCC license may be given as security for a loan, even if the FCC license itself may not be pledged. It is also the first case to hold that Bankruptcy Code § 552(a) prevents attachment of the proceeds of an FCC license unless a transfer is substantially completed before the petition date, undercutting those bankruptcy cases that have approved such an interest but not considered the effect of § 552(a).

Although not the first case to consider the issue, *Terrestar* is another significant case to follow as any decision will issue from the Southern District of New York, a district often looked to for banking law precedent in the bankruptcy context. Moreover, a second court's approval of *Tracy Broadcasting's* § 552 analysis would reinforce *Tracy's* application of § 552(a) to security interests in the proceeds of broadcast licenses, creating a solid line of authority to follow in future cases. But should *Terrestar* reject *Tracy*, the stage would be set for further appeals of both cases. Thus the final outcome in *Tracy* and *Terrestar* may provide new and important considerations for lenders when extending credit to broadcast entities.

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court determined that the indenture lacked a specific "no-call" provision and refused to read additional language into the agreements.

CALPINE II

On appeal from *Calpine I*, the district court found that CalGen's lenders were not entitled to secured or unsecured claims on account of the breach of the "no-call" provisions and alleged trigger of the "make-whole" provisions. The district court found that the "no-call" provisions could not be enforced via specific performance and thus did not give rise to any claims in the bankruptcy cases. The court concluded that § 502(b)(2) of the Bankruptcy Code prohibits claims under the "no-call" provisions as claims for unmatured interest as a result of the acceleration of the debt upon the bankruptcy filing. The court also found that the "make-whole" claims were not triggered in accordance with the terms of the "make-whole" provisions.

PREMIER ENTERTAINMENT

First-lien mortgage lenders of hotel owner and operator debtors asserted claims for damages arising from the breach of a "no-call" provision as a result of the debtors' repayment of the debt through their confirmed Chapter 11 plan in August, 2007. Under the indenture, the "no-call" provision would remain in effect until Feb. 1, 2008 and "make-whole" provisions provided for the repayment of the debt with a gradually decreasing premium payment thereafter until the maturity date in 2012. Certain events of default, such as a bankruptcy filing, resulted in automatic acceleration of the debt. The court declined to award a secured claim for damages because the indenture only required the payment of a "make-whole" premium if the debt was repaid prior to maturity, which occurred as a result of the acceleration provision in the indenture. The court, nevertheless, awarded an unsecured claim for breach of contract damages finding that unenforceable specific performance remedies did not preclude a monetary award. The court took note of the solvency of the debtors on a balance sheet basis and its duty to enforce creditors' rights in such situations. The damage award was ultimately based upon the difference between the present value of the expected interest payments at the contract rate and the market rate, plus interest calculated at the federal judgment rate from the date of the repayment.

CHEMTURA ROADMAP

After extensive review of the above conflicting decisions, the court crafted a guide with the analysis it might have undertaken if the "make-whole" and "no-call" provisions at issue were fully litigated before it.

First Prong: State Law Analysis

The *Chemtura* court stated that it would begin its analysis by looking to state law to determine "whether a payment or damages would become due, and, if so, to what extent … [The court would] first have to determine, as a matter of contractual interpretation, whether there was a breach of [the "no-call" provision] or trigger of [the "make-whole provision]." *Chemtura* at 600. To do so, the court would examine if a prepayment would indeed occur prior to maturity, or if the maturity changed by acceleration on the bankruptcy filing date or otherwise. If state law triggered a bondholder entitlement, the court would determine the appropriate damages for violation of a "no-call" provision and whether the "make-whole" award was appropriate under the circumstances, subject to disallowance as a penalty or warranted reduction to an appropriate amount.

The court noted that with respect to the 2016 Notes, a strong argument existed that the "make-whole"

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Canada Expands Judicial Assistance To the U.S.

Non-Monetary Judgment Recognized and Enforced For First Time

By David Ward

As commerce between the U.S. and Canada becomes increasingly intertwined, the courts of the land haven't always kept pace. But a recent decision by one of Canada's highest courts is going to make it easier to enforce U.S. decisions that reach north across the border.

While *United States v. Yemec* (2010 ONCA 414, 2010 CarswellOnt 3839) was not an insolvency case per se, the precedent it set will be highly relevant to U.S. bankruptcy and insolvency lawyers due to myriad civil litigation that typically flows from large cross-border insolvencies for years to come.

The core of *Yemec* centered on a group of Toronto-area telemarketers who purchased lottery tickets for residents of the United States. For some 20 years, George Michael Yemec and his 250 employees called tens of thousands of people a year offering to sell them packages or groupings of tickets of Canadian and other foreign lotteries. The packages generally sold for between \$100 and \$500, which represented a markup of between five and eight times above the actual cost of the tickets.

U.S. and Canadian Proceedings

In late 2002, the United States of America and the United States Federal Trade Commission brought proceedings in Illinois and in Ontario to prevent Yemec and his employees from continuing to operate.

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The U.S. government alleged the scheme was deceptive in violation of the Federal Trade Commission Act because chances of winning the lottery were not good and the consumers who sent money to redeem large prizes never received them.

While the Ontario suit bogged down in a fight over a Mareva injunction and an Anton Pillar order, which were granted and then later set aside, the Illinois case rolled along, resulting in a summary judgment of \$19 million against the defendants and a permanent injunction prohibiting them from telemarketing into the U.S.

The U.S. government then asked the Ontario claim to enforce the judgment. But a motion for partial summary judgment was dismissed on the grounds that there was a question as to whether the Canadian defendants had a "meaningful opportunity to be heard" in the U.S. proceedings. The U.S. government was granted leave to appeal the decision.

The Ontario Court of Appeal justices were asked to consider two novel issues as part of *Yemec*. The first was whether the available Canadian defenses to the enforcement of a U.S. judgment should be expanded.

A Fourth Defense?

The leading case in the area is *Beals v. Saldanha* (2003 SCC 72, [2003] 3 SCR 416), in which the Supreme Court of Canada lays out three traditionally accepted defenses: Jurisdiction, natural-justice and public policy. But the top court made it clear that the list of available defenses was not closed, and that new ones could be created as appropriate. Defendants in *Yemec* asked the Ontario Court of Appeal judges to do just that, to adopt a fourth defense based on the denial of a "meaningful opportunity to be heard."

The defendants argued they were unable to mount an effective defense in the United States because they were simultaneously fighting proceedings started by the U.S. government in both countries. They said they feared arrest if they entered the United States and so lacked access to seized business documents and computers, making it difficult for them to properly instruct counsel. They indicated that this deprived them of a full and fair opportunity to defend the U.S. proceedings. The court overturned the lower court's decision.

"There is nothing to suggest any unfairness to the defendants in the U.S. summary judgment proceeding," Justice James MacPherson wrote on behalf of the three-member appeals panel. He noted that U.S. District Court Judge Amy St. Eve had given the defendants a chance to review documents, which they didn't do. "The defendants had a meaningful opportunity to be heard," MacPherson said.

The Ontario Court of Appeal also explicitly rejected the proposed new defense, saying it duplicated the existing natural-justice defense because the right to be heard is one of its cornerstones. The appeals judges ruled against the defendants on the second novel issue, whether the long-standing common law rule that prevents the enforcement of foreign non-monetary judgments — in this case the permanent injunction — still holds firm or needs to be updated.

The defendants had argued that the traditional common law position in Canada is that foreign judgments are enforceable only if they are for a specific sum of money. The appeals court pointed to the guidance by the Supreme Court of Canada in *Pro Swing Inc. v. ELTA Golf Inc.*, (2006 SCC 52, [2006] 2 SCR 612), the leading case in area, in which the top court noted the time was "ripe" for a reconsideration of the absolute common-law bar to the enforcement of foreign non-monetary orders.

The Supreme Court justices set out several factors in *Pro-Swing* that lower courts should use in determining enforceability. They include whether the terms of the order are clear and specific, whether the originating court retains the power to issue further orders and whether the use of judicial resources in Canada would be consistent with what would be allowed for domestic litigants.

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The Ontario Court of Appeal held that the non-monetary part of the injunction prohibiting Mr. Yemec and his associates from telemarketing into the United States met all those tests, and should be upheld.

CONCLUSION

United States v. Yemec is highly relevant to issues of comity between Canada and the United States — two of the world's largest trading partners that also share the world's longest undefended border. It establishes that an absolute common-law ban on the enforcement of all foreign non-monetary judgments is no longer a given, a decision that will affect both commercial activity and judicial assistance in the very many areas of Canada-U.S. cross-border litigation and commerce.

U.S. attorneys who want to pursue a full range of bankruptcy remedies and realizations north of the border will find *United States v. Yemec* a useful tool in their arsenal. Whereas in the past they may have run into roadblocks with Canadian courts reticent about recognizing and enforcing non-monetary orders of U.S. courts, the Ontario Court of Appeal decision provides new authority for Canadian judges to do so in line with the wishes of the Supreme Court of Canada. The ruling will assist in the aggressive pursuit of all types of commercial litigation, including bankruptcy-related litigation designed to maximize estate assets and creditor recoveries.

The bottom line is that Canadian defendants dealing with disputed assets — and seeking to avoid dealing with U.S. judgments and orders in the process — now have fewer places to hide.

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provision was actually breached because the entitlement to a "make-whole" award was based upon payment prior to the actual maturity date, as opposed to the accelerated maturity, as was the case in *Solutia*. The court questioned whether the formula for determination of the "make-whole" award was appropriate as an estimate of lost interest or simply an unjustifiable penalty. Examining the indenture for the 2026 Notes, the court raised concerns of inadequate and unclear drafting — "as a matter of state law, the bondholders might have *Solutia* problems — inadequate drafting to give them the state law rights they wish to enforce — and it would be the bondholders' opponents who'd have the stronger argument." *Id.* at 603.

Second Prong: Enforceability in Bankruptcy

The second part of the court's analysis would require the consideration of the claims under the more restrictive requirements of federal bankruptcy law. Noting at the outset "the notion of specific performance is generally repugnant to bankruptcy policy," the court observed that bankruptcy courts often allow claims for damages for breach of contracts that they won't specifically enforce. Next, the court posited that "it's at least arguable that in bankruptcy cases, make-whole premiums and damages for breach of no-call are proxies for unmatured interest — and that where unmatured interest must be disallowed, they likewise should be disallowed." The court noted that the majority view disfavored disallowance but suggested that it may favor the minority view, which was only relevant in the (more common) case of the insolvent debtor, which was not the case in *Chemtura*. Finally, the court queried whether "no-call" and "make-whole" claims might be affected by the debtor's solvency. "With a solvent debtor, issues as to fairness amongst creditors, in sharing a limited pie, no longer apply; the allowance of claims under a make-whole provision, or for damages for breach of a no-call, no longer comes at the expense of other creditors." *Id.* at 605.

Upon examining these factors in depth, the court noted that the holders of the 2016 Notes, scheduled to receive 42% on account of their asserted claims, were in a stronger position than their opponents, while holders of the 2026 Notes, scheduled to receive 39% on account of their asserted claims, were in a weaker position compared with their opponents. Looking at the totality of the settlement, the court determined that the settlement overall was not unreasonable.

CONCLUSION

Chemtura and the decisions examined therein illustrate the various ways bankruptcy courts address the enforcement of claims arising under "no-call" and "make-whole" provisions. Until appellate courts offer more concrete guidance, difficulties in navigating these issues will remain. In this uncertain terrain, practitioners are encouraged to carefully draft and examine loan agreements to avoid unintended ambiguities.

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Supply Contracts

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the purpose of the specific agreements and industry usage and found that the supply forward contracts qualified as a "forward contract" protected by § 546(e) (addressing forward contracts). *See In re MBS Management Services, Inc.*, 430 B.R. 750, 757 (Bankr. E. D. La. 2010) (hereinafter, "*MBS I*"); *see also In re MBS Management Services, Inc.*, 432 B.R. 570, 577 (Bankr. E.D. La. 2010) (hereinafter, "*MBS II*") (finding that the subject contracts were protected by the safe harbor of § 546(e)).

A North Carolina bankruptcy court, in contrast, took a very narrow view of the safe harbor finding that the forward supply agreements were not protected by § 546(g) (addressing swap agreements). *In re National Gas Distributors, LLC*, 369 B.R. 884, 900 (Bankr. E.D.N.C. 2007) (hereinafter, "*National Gas I*") rev'd sub nom. *In re National Gas Distributors. LLC*, 556 F.3d 247 (4th Cir. 2009) (finding the bankruptcy court construed "forward agreement" too narrowly). Despite the Fourth Circuit's reversal,

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when the bankruptcy court faced the exact same question, it again found the forward supply agreements were not protected by the safe harbor of § 546(g), albeit for a different reason. *In re National Gas Distributors, LLC*, 412 B.R. 758 (Bankr. E.D.N.C. 2009) (hereinafter, "*National Gas II*"). This article analyzes the two courts' opinions and provides practical analysis of the effects of the decisions on other courts and the industry.

11 U.S.C. § 546

Under BAPCPA, Congress significantly expanded the protections of § 546 for financial derivative participants. *See National Gas*, 556 F.3d at, 255. For example, a forward transaction could be a swap agreement even if it is not a forward contract. *Id*. One commentator noted that "[t]he expanded definitions — especially the definition of 'swap agreement' — are now so broad that nearly every derivative contract is subject to the Code's protection." Edward R. Morrison and Joerg Riegel, Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges, 13 *Am. Bankr. Inst. L. Rev.* 641, 652 (2005).

In addition to providing protection to a broad array of financial instruments, these expanded definitions have created confusion. While the definition of a swap agreement is broad, traditional commercial arrangements do not fall within the exception provided by § 546 and, as such, merely labeling a contract a swap agreement is not sufficient to gain protection under that statute. Courts are required to determine whether a subject agreement is a derivative contract or a simple supply agreement. *See In re National Gas Distributors*, 556 F.3d at 258. Bankruptcy courts' reluctance to upset the priority scheme of bankruptcy by elevating form over substance may result in case law that ignores the complexities and the realities of the financial markets.

The *National Gas* Decisions

In *National Gas I*, the Trustee sought to avoid transfers made under natural gas supply contracts as fraudulent pursuant to § 548 (avoidance of fraudulent transfer). Three customers filed a motion to dismiss on the ground that the contracts were forward swap agreements protected by the safe harbor of § 546(g). The bankruptcy court noted that the statute's purpose was to protect the financial markets. While not deciding the boundaries of what a swap agreement includes, the bankruptcy court found that the subject agreements were "simply [agreements] by an end-user to purchase a commodity" and, as such, were not excluded as swap agreements. *Id*. at 899. The court reasoned "[i]f this agreement is a swap agreement, … then a farmer who contracts to sell his hogs at the end of the month for a set price [would also be protected by the safe harbor]." *Id*. at 900.

In stark contrast to the broad application of the statute set out in its legislative history, the court applied a decidedly narrow interpretation, noting that if 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." *National Gas I*, 369 B.R. at 900. Thus, the bankruptcy court denied the motion to dismiss.

On a direct interlocutory appeal from the bankruptcy court's order, the Fourth Circuit reversed the bankruptcy court's holding. The Fourth Circuit found that the bankruptcy court erred in holding that as a matter of law the subject contract was not included in the safe harbor because it was not traded on an exchange or in a financial market and involved physical delivery of the commodity to an end user. It explained that the statute's language and a substantial body of case law stands for the proposition that "swap agreements" can include agreements contemplating physical delivery. *National Gas*, 55 F.3d at, 258. Second, the Fourth Circuit noted "[a]lthough the contracts in this case did provide a supply of gas to the customers' facilities, they also were part of a series of contracts by which the customers hedged their risk of future fluctuations in the price of natural gas." *Id*. at 257. The Fourth Circuit observed that these contracts, although non-assignable and for the physical delivery, could influence the financial markets. For example, the Seventh Circuit explained that farmers' forward contracts with grain merchants affected commodities markets contracts because the grain merchants trade in established futures markets. *Nagel v. ADM Investor Servs., Inc.*, 217 F.3d 436, 438-39 (7th Cir. 2000). (Based on the reasoning of the Fourth and Seventh Circuits, the hog farmer addressed by the bankruptcy court is likely to be protected by the safe harbor.)

The Fourth Circuit remanded the case and provided four nonexclusive elements that the statutory language appears to require. "First, the subject of a commodity forward agreement must be a commodity." *National Gas* 556 F.3d, at 259. "Second, a forward commodity contract, in being 'forward,' must require a payment for the commodity at a price fixed at the time of contracting for delivery more than two days after the date the contract is entered into." *Id*. at 260. "Third, as a forward agreement in relation to a commodity, in addition to the price element, the quantity and time elements must be fixed at the time of contracting." *Id*. "Finally, […] swap agreements' also include forward contracts, which are not necessarily assignable." *Id*.

Did the *National Gas Distributors* Court Get It Right the Second Time?

The *National Gas* bankruptcy court had the opportunity to revisit forward supply contracts for natural gas with different defendants. While in its prior opinion the court addressed the effect of the subject contracts on the financial markets, this time the court barely addressed the issue. The court did not analyze whether the instruments were intended to be protected by BAPCPA's broad language or how the subject contract functioned in the market. Rather, the bankruptcy court focused on the Fourth Circuit's third non-exclusive element that the amount be

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ON THE MOVE

McCarter & English LLP announced that **Thomas H. Curran** has joined the firm as a partner in the Bankruptcy & Restructuring practice in Boston. Curran handles all aspects of insolvency law with a particular focus on creditor rights. Some of his key industries include real estate, construction, aircraft and corporate leasing as well as intellectual property rights pertaining to technology and biotechnology. Curran was previously a partner in the Bankruptcy, Creditors' Rights & Workouts practice group at **Hinckley, Allen & Snyder LLP** in Boston.

Mark J. Kalla has joined the Minneapolis office of **Barnes & Thornburg LLP** as partner in the firm's Finance, Insolvency and Restructuring Department. Kalla focuses his practice on bankruptcy and workout matters, corporate bond defaults, representation of various entities in commercial disputes and documentation of asset-based loans, including debtor-in-possession financing. He joins the firm from **Dorsey & Whitney LLP**.

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Supply Contracts

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fixed at the time of contracting. The defendants argued that the unique aspects of natural gas do not require a swap agreement to have a fixed amount. *National Gas II*, 412 B.R. at 766. Not surprisingly, the bankruptcy court found that the subject contracts lacked a fixed amount and, as a matter of law, the contracts were not forward swap agreements. *Id*.

In re MBS Management Services

In *In re MBS*, the court was faced with a question whether a supply contract for electricity can qualify as a forward contract for the purposes of 11 U.S.C. § 546(e). The trustee/plaintiff sought to avoid transfers made pursuant to a supply contract for electricity, arguing that such a contract "lacks the hallmarks of a hedging or forward transaction and provides an imperfect hedge." *MBS I*, 430 B.R. at 756. The trustee later refined his argument that "hedging was not the primary goal, and as such it was not a forward contract." *MBS II*, 432 B.R. at, 577 . Furthermore, the trustee invoked *National Gas II's* guidance regarding the absence of a specified amount in the supply contract. The court noted that the statute contains few requirements for a contract to qualify as a forward contract: "(a) sale of a commodity; (b)with a maturity date more than two days after execution; (c) by a forward contract merchant; [and] (d) not otherwise subject to the rules or market of a contract board of trade." *MBS I*, 430 B.R. at, 754. The court found in addition to these statutory requirements, "industry standards, risks, and market practices should govern the criteria necessary to define any particular contract as fitting within the statute's definition." *Id*. at 757. The court explained that a crucial element in its analysis is whether "the primary risk to those purchasing electricity is price volatility" and "the contract acts as a hedge against the primary risk to both buyer and seller." *Id*. Thus, the court found based on the evidence and expert testimony that the subject electric supply contract served to hedge against fluctuating prices and, as such, was protected by the safe harbor under 546.

Importantly, *MBS* analyzed the *National Gas II's* holding that a forward contract requires a fixed amount. *National Gas* noted that "*The Wall Street Journal* always quotes commodity contracts by price and quantity, observing that both must be specified in order for a forward contract to exist." *Id*. at 576. *MBS* distinguished those contracts, explaining that they were future contracts and regulated and traded on exchanges and, as such, require uniformity. In contrast, forward contracts are off-exchange trades, and, as a result, they often vary in their terms. Thus, limiting the safe harbor to forward contracts containing "a condition that is not typically present would defeat the purpose of § 546(e) by narrowing its application." *Id*.

Looking Forward

The disparate approaches of these decisions highlights the uncertainty that counterparties are faced with when entering into forward supply agreements. This uncertainty may be limited by bifurcating the contract into separate sections, one addressing the minimum requirements (which will be protected by the safe harbor) and a second section addressing the unknown (both the amount required and the treatment in bankruptcy). Likewise, to meet the hyper technical requirement of *National Gas*, a forward supply agreement could be recast as a fixed contract for the maximum possible amount with a rebate for the unused portion.

Conclusion

These recent rulings by bankruptcy courts in North Carolina and Louisiana provide important guidance beyond those districts regarding forward supply contracts. As other courts have not addressed these contracts directly, these decisions serve as a road map for how a court may analyze any forward supply contracts. Additionally, a court's general approach to the safe harbor of § 546 provides valuable guidance. A court that has broadly interpreted the statute or values economic theory is more likely to follow the *MBS* approach. In contrast, courts that have narrowly construed the statute will likely follow the bankruptcy court's decision in *National Gas*.

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