

Contracts for Commodities: Forward Contract or Commodity Contract

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I. INTRODUCTION

The recent opinion issued by the Fourth Circuit Court of Appeals *In re National Gas Distributors, LLC* has raised new awareness of the consequences of the definitions that relate to agreements for the sale or purchase of commodities with a future delivery date. The court, unfortunately, was not consistent in its use of terms.

Under the Bankruptcy Code, there is no definition for a “commodity forward agreement” or “forward commodity contract” or “forward agreement.” Yet the court uses all these terms in the span of a few paragraphs when discussing forward contracts. Presumably, the court was trying to describe a contract for a commodity that meets the requirements for a forward contract. This article attempts to provide clarity among words and terms that are often casually used despite precise definitions existing in the Code.

II. CASE LAW

Recently, the Fourth Circuit Court of Appeals, in *In re National Gas Distributors, LLC*,¹ held that a “commodity forward agreement” need not be traded on an exchange or in a financial market. On January 20, 2006, National Gas (the Debtor) filed for relief under Chapter 11 of the Code, and the bankruptcy court appointed Richard M. Hutson III, as the trustee.² In the year prior to the Debtor’s bankruptcy filing, the Debtor’s customers, E.I. du Pont de Nemours and Company, Smithfield Packing

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Company, Inc., and Stadler's Country Hams, Inc., (collectively, the Customers), purchased natural gas for facilities under a series of contracts with the Debtor.³ The natural gas contracts consisted of a "Base Contract for Sale and Purchase of Natural Gas" and confirmation e-mails of phone conversations between the parties in which the price of future deliveries of natural gas was fixed during specified time periods.⁴ Performance of the contracts formed in this way commenced more than two days after the contract's formation and fixed the price of gas for a period of months for each specified facility.⁵ The Debtor was required under the contracts to sell and deliver the gas, and the customer was required to receive and purchase the gas at the specified price, regardless of the market price, or to pay the difference between the market price and the agreed-upon price.⁶ The contracts provided a hedge against fluctuations in the market price of natural gas and the adverse effects such fluctuations might have on the Customers' operations.⁷

The Trustee sued Nemours and Smithfield seeking to avoid the contracts under Code § 548(a) on the ground that the contracts and transfers were fraudulent.⁸ The Trustee alleged that the Debtor entered into the natural gas contracts with the Customers at below-market prices, and at the time of the contracts, the Debtor was insolvent, and therefore, this resulted in a constructive fraudulent conveyance under Code § 548(a)(1)(B).⁹ In the alternative, the Trustee alleged that the Debtor's former management intentionally used the contracts to "hinder, delay, or defraud" its creditors, thereby engaging in an actual fraudulent conveyance under Code § 548(a)(1)(A).¹⁰

The Customers filed motions to dismiss the complaint, arguing that the Trustee could not avoid the contracts and transfers because each was made in accordance with a swap agreement, and thus was not avoidable under Code §§ 546(g) and 548(d)(2)(D).¹¹ The Customers asserted that a "swap agreement" is defined in Code § 101(53)(B) to include a "commodity forward agreement," which, they alleged, covers natural gas supply contracts.¹² The bankruptcy court denied the Customers' motions to dismiss and concluded that the natural gas supply contracts were not "commodity forward agreements."¹³ The bankruptcy court ruled that the natural gas supply contracts were insufficiently tied to financial markets to be commodity forward agreements.¹⁴ The bankruptcy court also held that a commodity forward agreement must be the regular subject of trading in financial markets and must be settled by financial exchanges of the differences of commodity contracts, while the contracts between the Customers and the Debtor were directly negotiated by the parties and contemplated physical delivery.¹⁵ The district

court granted the Customers permission to file an interlocutory appeal and certified the questions for direct appeal.¹⁶

The Fourth Circuit began its analysis by examining the 2005 Amendments to the Bankruptcy Code in which Congress expanded the protections to financial derivative participants and transactions by expanding the definition of “swap participants” and “swap agreements” that are exempted from the avoidance powers and automatic stay provisions of the Code.¹⁷ The definition of “swap agreement” was expanded to cover several dozen enumerated contracts and transactions, including combinations of them, options on them, and similar contracts.¹⁸ The Code now protects all counterparties to these transactions.¹⁹ Next, the Fourth Circuit recounted that Code § 548(a) permits a trustee in bankruptcy to avoid contracts and transfers of the debtor’s property “made or incurred on or within 2 years before the date of the filing of the petition” when the contract or transfer amounts to a fraudulent transfer as defined under Code § 548(a).²⁰ Transfers, however, made by a swap participant or financial participant in connection with a swap agreement are exempted, pursuant to Code § 546(g), from the avoiding powers of Code § 548(a).²¹

The Customers invoked the protections of Code §§ 546(g) and 548(d) (2)(D), arguing that the natural gas supply contracts with the Debtor were “swap agreements” as defined in Code § 101(53B) in that they were “commodity forward agreements,” a group of transactions listed in the definition of “swap agreement.”²² “Commodity forward agreements” are not defined in the Code, and there is little case law discussing them.²³

The Fourth Circuit recounted the bankruptcy court’s decision. The bankruptcy court held that the natural gas supply contracts were not commodity forward agreements exempt from the Trustee’s avoidance powers because, according to the bankruptcy court, all of the agreements and transactions listed in Code § 101(53)(B)(A)(i) were “financial instruments traded in the swap markets,” and thus, if any agreement was not traded on a financial market or exchange, it could not be a swap agreement.²⁴ The bankruptcy court, the Fourth Circuit recounted, concluded that because the contracts at issue were agreements by a single-end user to purchase a commodity that was physically delivered to the purchaser, such contracts were not swept into the “swap agreement” definition.²⁵

The Fourth Circuit was skeptical of the bankruptcy court’s assumption that all swap agreements, including commodity forward agreements, must be traded on exchanges or financial markets.²⁶ The Fourth Circuit explained that because the term “agreement” is broader than the term “contract,” a forward contract is also a forward agreement.²⁷ The Fourth Circuit then proceeded to examine the Code’s definition of for-

ward contract in order to determine whether the bankruptcy court gave too restrictive a definition of forward agreement.²⁸ The Code, pursuant to § 101(25)(A), defines “forward contracts” to mean a “contract” (other than a commodity contract) while a “commodity contract” specifically includes contracts, “on, or subject to the rules of, a contract market or board of trade.”²⁹ The Fourth Circuit explained that because Congress explicitly excluded commodity contracts from the definition of forward contracts, Congress intended that forward contracts need not be traded on any exchange or financial market.³⁰ The Fourth Circuit continued to explain that other courts have found that forward contracts do not need to be traded on an exchange or in a financial market and could be even directly negotiated, similar to the contracts in this case.³¹ Because the overwhelming authority, according to the Fourth Circuit, indicates that forward contracts are not found only in the financial markets but also may be directly negotiated, as a result, every forward contract is also a forward agreement. Thus the Fourth Circuit rejected the lower court’s assumption that all of the agreements listed in Code § 101(53B)(A)(i) must be found on financial markets.³²

Furthermore, the Fourth Circuit dismissed the lower court’s conclusion that the contracts in this case were simple supply contracts, and therefore, the rationalization that contracts were not in the definition of swap agreements was an oversimplification.³³ The Fourth Circuit explained:

Although 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. Although it is true that 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. A business can enter into a forward agreement with a party who then, in reliance on that forward agreement, enters into another contract with yet another market participant, who in turn may enter into even other contracts. And so a simple forward agreement may readily become tied into the broader markets that Congress aimed to protect in BAPCPA.³⁴

Here, the Customers claimed a similar relationship with the markets, alleging that their contracts with the Debtor were hedging contracts that were part of a larger risk management in which the Customers used derivatives.³⁵

III. THE SIGNIFICANCE OF FORWARD CONTRACTS

The opinion of the Court in *National Gas* left open the possibility that a contract for a commodity can be a forward contract. Why does it matter if something is a forward contract or commodity contract? Legislative history supports that Congress, through the Code, sought to protect agreements that were intended in themselves to protect against price fluctuations.³⁶ Congress further sought to protect contracts for commodities that were either commodities contracts or forward contracts in order to provide stability in the commodities market.³⁷

The Code provides significant benefits to certain persons that are parties to certain contracts. These provisions are often referred to as safe harbor provisions. Understanding whether a contract fits within a safe harbor provision can impact what rights, remedies, and defenses are available under the Code. A particular safe harbor provision may impact a party's right to offset or liquidate, terminate, or accelerate a contract without violating the automatic stay or may provide a party a complete defense to an avoidance action. Below are a few of the safe harbor provisions that exist for forward contract merchants.

A. Section 362(b)(6): Exception to the Automatic Stay for Forward Contract Merchant

Section 362(b)(6) provides that the automatic stay does not apply to:

the exercise by a... forward contract merchant... of any contractual right... under any security agreement or arrangement or other credit enhancement forming a part of or related to any... forward contract..., or of any contractual right... to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such contracts, including any master agreement for such contracts.³⁸

This means that a forward contract merchant can exercise its right to offset or net out any termination value, payment amount, or other transfer obligation arising under its contract. This assumes such right is granted in the underlying contract.

The ability to offset without seeking relief from the stay is a major advantage from an expense perspective. The expense associated with seeking relief from the stay can be significant if a party objects and disputes the relief sought. Thus a contract that provides for the right to offset and qualifies as a forward contract will receive the benefits of Code § 362(b)(6).

B. Section 556: Forward Contract Merchant's Right to Liquidate, Terminate, or Accelerate a Commodity Contract

Section 556 provides that:

The contractual right of a... forward contract merchant to cause the liquidation, termination, or acceleration of a commodity contract, as defined in section 761 of this title, or forward contract because of [the commencement of a case under the Code]... shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by the order of a court in any proceeding under this title. As used in this section, the term "contractual right" includes a... right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice.³⁹

Again, a forward contract merchant is afforded rights that other parties may not be afforded. Note, however, that the forward contract merchant is still limited to only the rights that it may have under the contract or law. Thus, as an example, if a forward contract does not contain a provision that allows for termination upon bankruptcy filing, then the forward contract merchant may not terminate the contract upon the bankruptcy filing; whereas, if the forward contract does contain such a provision, then Code § 556 allows the forward contract merchant to exercise such right of termination notwithstanding the automatic stay.

C. Section 546(e): Defense to Avoidance Actions for Forward Contract Merchants

Section 546(e) provides forward contract merchants a defense to avoidance claims, other than actual fraudulent transfers, when the transfer is a settlement payment.⁴⁰ The terms "forward contract merchant" and "settlement payment" are defined in the Code.⁴¹

IV. DEFINING ALL OF THE PARTS OF A FORWARD CONTRACT MERCHANT

Because there are safe harbor provisions for forward contract merchants, it is necessary to know what it means to be a forward contract merchant.

A. Defining Forward Contract Merchant

A forward contract merchant includes an entity whose business consists in whole or in part of entering into forward contracts as or with merchants in a commodity.⁴² Because the definition uses the words "in

whole or in part,” the definition includes essentially any forward contract, except for a forward contract among two nonmerchants.⁴³

A forward contract merchant is defined as:

a Federal reserve bank, or an entity the business of which consists in whole or in part of entering into forward contracts as or with merchants in a commodity (as defined in section 761) or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade.⁴⁴

To understand this definition, it is necessary to understand the terms “forward contracts” and “commodity” used within the definition itself.

B. Defining Forward Contract

Section 101(25) provides that:

The term “forward contract” means—

(A) a contract (other than a commodity contract, as defined in section 761) for the purchase, sale, or transfer of a commodity, as defined in section 761 (8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase or reverse repurchase transaction (whether or not such repurchase or reverse repurchase transaction is a “repurchase agreement”, as defined in this section) consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any other similar agreement.⁴⁵

To understand the definition for forward contract, we must understand the words used in the definition itself, including the terms “commodity contract,” “commodity,” “forward contract trade,” and “maturity date.”

1. Commodity Contract

A contract for a commodity, not surprisingly, involves the sale or purchase of a commodity. In the marketplace for commodities, there are only two categories: (1) on-exchange futures transactions, and (2) off-exchange forward contracts.⁴⁶ A commodity contract, in the Code, is limited to on-exchange futures transactions or contracts for commodities for future delivery that are subject to a contract market or board of

trade.⁴⁷ The Code specifically excludes commodity contracts from the definition of a forward contract. Thus an off-exchange contract for the purchase or sale of a commodity would qualify as a forward contract if the contract otherwise meets the requirements for a forward contract.⁴⁸

Code § 761 provides:

- (4) “commodity contract” means—
- (A) with respect to a futures commission merchant, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade;
 - (B) with respect to a foreign futures commission merchant, foreign future;
 - (C) with respect to a leverage transaction merchant, leverage transaction;
 - (D) with respect to a clearing organization, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization, or commodity option traded on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization;
 - (E) with respect to a commodity options dealer, commodity option;
 - (F) any other agreement or transaction that is similar to an agreement or transaction referred to in this paragraph;
 - (G) any combination of the agreements or transactions referred to in this paragraph;
 - (H) any option to enter into an agreement or transaction referred to in this paragraph;
 - (I) a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), (C), (D), (E), (F), (G), or (H), together with all supplements to such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a commodity contract under this paragraph, except that the master agreement shall be considered to be a commodity contract under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in subparagraph (A), (B), (C), (D), (E), (F), (G), or (H); or

- (J) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this paragraph, including any guarantee or reimbursement obligation by or to a commodity broker or financial participant in connection with any agreement or transaction referred to in this paragraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562.⁴⁹

The distinction of a commodity contract and forward contract is often confused. A commodity contract cannot be a forward contract because the term forward contract has a defined meaning that expressly excludes a commodity contract. Because not every contract for commodity is commodity contract as defined in the Code, a contract for a commodity can be a forward contract. The use of a word or term requires precision because the implication can be far reaching. Thus a contract involving a commodity should not be called a commodity contract unless it meets the specific defined meaning provided in the Code.

2. Commodity

A commodity is a defined term that can be the subject of either a commodity contract or a forward contract. The Code defines commodity by incorporating the definition found in the Commodity Exchange Act.⁵⁰ In the Commodity Exchange Act, commodity is defined as:

wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, *Solanum tuberosum* (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions as provided in section 13-1 of this title, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.⁵¹

The definition is broad in that it includes all goods and articles, except onions, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt.

3. Forward Contract Trade

The term “forward contract trade” found within the definition of a forward contract is not defined in the Code. Forward contract trade, presumably, means trade in forward contracts. The term “trade” is defined

in the Merriam-Webster Dictionary to mean “a customary course of action.”⁵² Thus a plain-meaning interpretation of forward contract trade would mean the customary course of action for forward contracts. This definition is circular and not overly helpful. The forward contract trade element of a forward contract requires that the particular contract at issue be used in the customary course of action for forward contracts. The question still remains as to each particular contract at issue, including supply contracts, whether the contract is considered a customary course of action for forward contracts. Because the definition is circular, this requirement is really no requirement at all.

4. Maturity Date

The forward or future requirement for a forward contract requires that the contract have a maturity date greater than two days after the date on which the contract was entered.⁵³ This means that the price for the commodity in the contract is fixed at the time of contracting but that delivery must occur more than two days after the date of contracting.⁵⁴ A future maturity date in a contract for a commodity makes the benefit or detriment from the contract dependent on future fluctuations in market price of the commodity.⁵⁵

In addition to the price being fixed, the quantity and timing for delivery must be fixed at time that the contract is entered.⁵⁶ By having the quantity and time fixed, the parties are protecting themselves against future fluctuations in the commodity market.

IV. CONCLUSION

In deciding whether a supply contract qualifies as a forward contract, a court must find that contract is: (1) for the purchase or sale of a commodity, (2) in the future, and (3) the purchase or sale is not subject to the rules of a contract market or board of trade.⁵⁷ In contrast, if a contract for the purchase or sale of a commodity in the future is subject to the rules of a contract market or board of trade, then it would qualify as a commodity contract.

The inherent dilemma in the opinion in *National Gas* is the natural tendency to use the term “supply contract” for what could be a forward contract. If a contract meets the requirements for a forward contract, then it is a forward contract. In trying to determine that a supply contract is or is not a forward contract, the analysis becomes misguided. The definition for a forward contract is precise. If a particular contract, supply or not, fits within that definition, then Congress has provided certain benefits or protections for the contract.

NOTES

1. In re National Gas Distributors, LLC, 556 F.3d 247, 51 Bankr. Ct. Dec. (CRR) 56, Bankr. L. Rep. (CCH) P 81417 (4th Cir. 2009).
2. National Gas, 556 F.3d at 251.
3. National Gas, 556 F.3d at 250.
4. National Gas, 556 F.3d at 250.
5. National Gas, 556 F.3d at 250.
6. National Gas, 556 F.3d at 251.
7. National Gas, 556 F.3d at 251.
8. National Gas, 556 F.3d at 251.
9. National Gas, 556 F.3d at 251.
10. National Gas, 556 F.3d at 251.
11. National Gas, 556 F.3d at 251.
12. National Gas, 556 F.3d at 251.
13. National Gas, 556 F.3d at 251.
14. National Gas, 556 F.3d at 251.
15. National Gas, 556 F.3d at 252.
16. National Gas, 556 F.3d at 252.
17. National Gas, 556 F.3d at 253.
18. National Gas, 556 F.3d at 253.
19. National Gas, 556 F.3d at 253.
20. National Gas, 556 F.3d at 254.
21. National Gas, 556 F.3d at 254.
22. National Gas, 556 F.3d at 254-255.
23. National Gas, 556 F.3d at 254-255.
24. National Gas, 556 F.3d at 255 (relying on In re National Gas Distributors, LLC, 369 B.R. 884, 898-99, 48 Bankr. Ct. Dec. (CRR) 84, 57 Collier Bankr. Cas. 2d (MB) 100, Bankr. L. Rep. (CCH) P 80967 (Bankr. E.D. N.C. 2007), rev'd and remanded, 556 F.3d 247, 51 Bankr. Ct. Dec. (CRR) 56, Bankr. L. Rep. (CCH) P 81417 (4th Cir. 2009).
25. National Gas, 556 F.3d at 256 (citations omitted).
26. National Gas, 556 F.3d at 256.
27. National Gas, 556 F.3d at 256.
28. National Gas, 556 F.3d at 256.
29. National Gas, 556 F.3d at 256 (citing 11 U.S.C.A. § 761(4)).
30. National Gas, 556 F.3d at 257 (relying on In re Borden Chemicals and Plastics Operating Ltd. Partnership, 336 B.R. 214, 218, 45 Bankr. Ct. Dec. (CRR) 251 (Bankr. D. Del. 2006)).
31. National Gas, 556 F.3d at 257 (citing In re Olympic Natural Gas Co., 294 F.3d 737, 741, 39 Bankr. Ct. Dec. (CRR) 221, Bankr. L. Rep. (CCH) P 78683, 159 O.G.R. 555 (5th Cir. 2002)).
32. National Gas, 556 F.3d at 257 (quotations omitted) (citations omitted).
33. National Gas, 556 F.3d at 257.
34. National Gas, 556 F.3d at 257.
35. National Gas, 556 F.3d at 258.
36. Borden, 336 B.R. at 221 (discussing and citing legislative history and concluding that “[i]t is clear from these statements that Congress intended to reach agreements whose purpose was to protect against the uncertainty of price fluctuations”).
37. Borden, 336 B.R. at 223.
38. 11 U.S.C.A. § 362(b)(6).

39. 11 U.S.C.A. § 556.
40. 11 U.S.C.A. § 546(e).
41. 11 U.S.C.A. § 101(26), (51A).
42. 11 U.S.C.A. § 101(26).
43. Borden, 336 B.R. at 225 (citing 5 Collier on Bankruptcy § 556.03[2] at 556-6 (15th ed. rev. 2001)).
44. 11 U.S.C.A. § 101(26).
45. 11 U.S.C.A. § 101(25).
46. In re Olympic Natural Gas Co., 294 F.3d 737, 741, 39 Bankr. Ct. Dec. (CRR) 221, Bankr. L. Rep. (CCH) P 78683, 159 O.G.R. 555 (5th Cir. 2002) (citing 5 Collier on Bankruptcy ¶ 556.02[2], at 556-5 (Lawrence P. King ed., 15th ed. 2002))
47. Olympic, 294 F.3d at 741.
48. Olympic, 294 F.3d at 741-42.
49. 11 U.S.C.A. § 761(4).
50. 11 U.S.C.A. § 761(8).
51. 7 U.S.C.A. § 1a(4).
52. Merriam-Webster Dictionary Online (2009): trade.
53. 11 U.S.C.A. § 101(25).
54. National Gas, 556 F.3d at 260.
55. National Gas, 556 F.3d at 259-260.
56. National Gas, 556 F.3d at 260.
57. See Borden, 336 B.R. at 218 (citing 5 Collier on Bankruptcy ¶ 556.02[2], at 556-5 (15th ed. Rev. 2002)).