

## **The Current State of the Bankruptcy Code Safe Harbor Protections for “Financial Contracts”**

By

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The Bankruptcy Code specially protects “commodity contracts”, “forward contracts”, “securities contracts”, “repurchase agreements” and “swap agreements”, as well as related “master netting agreements”, as each of those terms is defined in the Code,<sup>1</sup> between the debtor and specified categories of counterparties. Such contracts and agreements are variously referred to as “financial contracts”, “derivative contracts” or simply “safe harbor contracts”. The automatic stay does not apply to the exercise by protected counterparties “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 agreements”<sup>2</sup>. In addition, a contractual right “to cause the liquidation, termination, or acceleration of or to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with” a safe harbor contract “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.”<sup>3</sup> A bankruptcy trustee may not avoid a transfer by, to or for the benefit of a protected counterparty in connection with a safe harbor contract, except as an actual fraudulent transfer.<sup>4</sup> Finally, protected counterparties under safe harbor contracts receive some protection from the general prohibitions on acquiring setoff rights during the 90 days before bankruptcy, although the protections here are ambiguously drafted.<sup>5</sup>

Two recent bankruptcy decisions address the safe harbor protections’ application in two very different contexts, with mixed results. The first ruled that a cross-affiliate setoff provision in two separate safe harbor contracts between a counterparty and two

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<sup>1</sup> 11 U.S.C. §§ 101(25), (38A), (47), (53B), 741(7), 761(4); All references to the “Code” are to the Bankruptcy Code, 11 U.S.C. § \_\_\_\_.

<sup>2</sup> 11 U.S.C. § 362(b)(6) (commodity contract, forward contract or securities contract). Similar language applies to the other safe harbor contracts.

<sup>3</sup> 11 U.S.C. §§ 561 (master netting agreements). Similar language applies to securities contracts (§ 555), commodities contracts and forward contracts (§ 556), repurchase agreements (§ 559) and swap agreements (§ 560).

<sup>4</sup> 11 U.S.C. § 546(e), (f), (g).

<sup>5</sup> 11 U.S.C. § 553(a)(2)(B), (a)(3).

affiliated debtors was not enforceable.<sup>6</sup> The second reversed a bankruptcy court decision that the safe harbor protections do not apply to ordinary commodity supply agreements.<sup>7</sup>

### **In re SemCrude, L.P.: Bankruptcy Court Disallows Triangular Setoff**

*The United States Bankruptcy Court for the District of Delaware, in a decision announced January 9, 2009, denied a creditor's request for permission to effect a triangular setoff, that is a setoff of the creditor's claim against one debtor against amounts the creditor owed to another debtor affiliate of the debtor. The decision, if widely followed, could substantially increase a company's credit exposure if the company has multiple contracts with another corporate group's affiliates and has relied on a provision in the contracts allowing the company to offset amounts owing to one affiliate against claims against another affiliate and if the other group's affiliates later file bankruptcy. The bankruptcy court ruled that allowing such a setoff would be inconsistent with the Bankruptcy Code's express setoff provision and with fairness to all creditors.*

**Background.** Chevron USA, Inc. had entered into numerous contracts for the purchase or sale of various petroleum products with three affiliates of SemCrude, L.P., each of which later filed bankruptcy. Bilateral master agreements each contained a broad version of a common cross-affiliate setoff provision:

“in the event either party fails to make a timely payment [or] delivery ... due and owing to the other party, the other party may offset any deliveries or payments due under this or any other Agreement between the parties and their affiliates”. (emphasis added.)

As of the bankruptcy petition date, Chevron owed \$1.4 million to SemCrude and was owed various amounts by the affiliates and sought to effect a “triangular setoff”.

**Decision.** The bankruptcy court denied permission for the triangular setoff. The court concluded that although the contracts permitted the setoff, Bankruptcy Code section 553 imposes the requirement that debts to be offset must be “mutual”.

Chevron relied on a line of case law to argue that a valid, prepetition contract providing for triangular setoff either satisfies section 553's mutuality requirement or that the parties may contract around it. The court found that none of the cases actually had permitted a triangular setoff.

The Bankruptcy Code does not define “mutual”. Case law is clear, however, that debts are “mutual” only when “they are due to and from the same persons in the same

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<sup>6</sup> In re SemCrude, L.P., Case No. 08-11525, United States Bankruptcy Court for the District of Delaware, Docket No. 2754 (Jan. 9, 2009).

<sup>7</sup> Nat'l Gas Distr's v. E.I. duPont de Nemours and Co., Inc. (In re Nat'l Gas Distr's, LLC), Case No. 07-2105 (Feb. 11, 2009).

capacity.” On its face, then, the mutuality requirement prohibits triangular setoffs of the type Chevron proposed. The court therefore rejected the argument that debts owing among different parties are “mutual” based on contractual netting provisions. The court also ruled against a “contractual exception” to section 553’s mutuality requirement.

Though some may view a cross-affiliate setoff provision as a de facto guarantee, the court did not and expressly excepted guarantees from the scope of its decision. Because all of the master agreements were bilateral, the court did not address multi-lateral agreements at all.

Although the court’s decision rested on a strict reading of section 553, it also noted that it was “consistent with the purpose of section 553 and the broader policies of the [Bankruptcy] Code [that] similarly-situated creditors are treated fairly and enjoy an equality of distribution . . . . By allowing parties to contract around the mutuality requirement of section 553, one creditor or a handful of creditors could unfairly obtain payment from a debtor at the expense of other creditors, thereby upsetting the priority scheme of the Code and reducing the amount available for distribution to all creditors”. “Such a result is clearly contrary both to the text of the Code and to the principle of equitable distribution that lies at the heart of the Code.”

Chevron has since filed a motion for reconsideration. Chevron argues that the contracts are safe harbors contracts (apparently, contrary to its position at the original hearing on the motion) and that the safe harbor protections prohibit “any provision of this title [11]”, including section 553, from limiting the operation of the setoff provisions of the agreements. The motion is currently set for hearing on March 12, 2009. A decision is expected soon after the hearing.

**The Effect of the Decision.** Although not precedential, if the decision is widely followed, it would render largely unenforceable bi-lateral triangular setoff provisions, cross-affiliate setoff provisions and master netting agreements that provide for setoff among different entities in corporate groups. Contract counterparties may resort instead to express cross-affiliate guarantees or to multi-lateral agreements, which might provide the necessary mutuality.

### **In re Nat’l Gas Distr’s.: Court of Appeals Protects Commodity Supply Agreements from Bankruptcy**

*The United States Court of Appeals for the Fourth Circuit, in a decision announced February 11, 2009, ruled that a natural gas supply agreement between a natural gas distributor and its customer may be eligible for protection under the financial contracts “safe harbor” provisions of the Bankruptcy Code. Although the Court of Appeals returned the case to the bankruptcy court for further proceedings to determine whether the safe harbor applies to these particular gas supply agreements, the decision makes clear that ordinary commodity supply contracts that contain real hedging elements, even those not directly linked to or traded on a financial market, can be protected. By permitting such contracts to be covered by the safe harbor provisions, the Court gives substantial additional rights and leverage to those contracting with a*

*counterparty that later files bankruptcy and makes reorganization substantially more difficult for those companies that need bankruptcy protection.*

**Background.** National Gas Distributors, LLC had entered into numerous contracts to supply natural gas to end users for various periods of time, beginning more than two days after the contract date, and at specified prices and quantities for the terms of the contracts. National Gas later filed bankruptcy. The bankruptcy trustee sought to avoid the contracts as “fraudulent transfers” on the ground that National Gas was insolvent at the time it made the contracts and did not receive reasonably equivalent value for its obligations under the contracts because the contract prices were below market prices.

The Code defines “commodity contract” to include only a futures contract traded on a contract market or board of trade and related agreements and “forward contract” to include a contract (except for a “commodity contract”) for the future purchase of a commodity. “Swap agreement”, however, is defined more broadly to include “a commodity swap, option, future, or forward agreement” (emphasis added). The bankruptcy court held that the supply agreements were not “commodity forward agreements”, because they were not the subject of trading in the financial markets or financially settled but “were directly negotiated between the seller and purchaser and contemplated physical delivery of the commodity”. The bankruptcy court therefore permitted the trustee’s fraudulent transfer action to proceed.

**Decision.** The Court of Appeals reversed. It concluded that a “commodity forward agreement” need not be traded (or of a kind traded) on an exchange to qualify for the safe harbor protections. Nor does the Code require that a commodity forward agreement be financially settled to qualify. Although the agreements here were simple supply agreements that were to be physically settled, they also had hedging elements, because they involved prices and quantities specified at the time of contracting and therefore were similar to forward contracts that are financially settled as hedges. The hedging elements made these contracts sufficiently similar to those financial markets contracts that Congress intended to protect.

The Court of Appeals did not, however, find that the supply agreements were protected “commodity forward agreements”. Having overruled only the bankruptcy court’s touchstones of trading on financial markets and financial settlement, the Court of Appeals remanded to the bankruptcy court, with some guidance, to decide whether the contracts qualify for safe harbor protection. First, for a commodity supply agreement to qualify, the agreement’s subject must be a commodity, with substantially all performance costs attributable to the commodity cost (as distinguished from other supply contracts that include costs attributable to packaging, marketing, transportation or service). Second, the agreement must be “forward”, that is, for delivery more than two days hence. Third, the agreement must fix not only the price, but also the time and quantity of deliveries. Finally, even though financial market trading is not required for an agreement to qualify, there must be some relationship between the agreement and the financial markets, a relationship that the Court of Appeals did not define but that might be similar to the hedging elements in the contracts at issue in this case, so that the Code’s safe harbor

provisions subordinate the Code's overarching equal distribution policy only when necessary to serve Congress's policy, embodied in the safe harbor provisions, of protecting financial markets.

**The Effect of the Decision.** The decision should provide substantial protection against bankruptcy risk to a party in a commodity supply relationship with a counterparty who later files bankruptcy, substantially reducing the nonbankrupt party's financial risk. For example, a party may terminate a commodity forward agreement upon the counterparty's bankruptcy, despite the bankruptcy automatic stay, if the price is no longer advantageous. In addition, the party will not be subject to preference recovery for payments received within 90 days before bankruptcy.

The decision will not, however, reduce credit risk. Even though a transaction may be protected from bankruptcy, the transaction remains subject to ordinary counterparty credit risk. Therefore, even the powerful financial contracts safe harbor provisions do not provide complete protection. A counterparty failure can result in transaction disruptions and transaction costs. As a result, bankruptcy safe harbor protection should not be viewed as reducing the need for sound credit analysis that should be a part of any transaction.