UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF NORTH CAROLINA
WILSON DIVISION

IN THE MATTER OF: **National Gas Distributors, LLC,** **Debtor**	**Case No. 06-00166-8-ATS** **Chapter 11**
Richard M. Hutson, II, Trustee for National Gas Distributors, LLC, f/k/a Paul Lawing, Jr., LLC, **Plaintiff** **v.** **The Smithfield Packing Company, Incorporated,** **Defendant**	**Adv. Pro. No. 06-00267-8-ATS**
Plaintiff's Memorandum in Opposition to Defendant's Motions to Dismiss and for Summary Judgment	

I. INTRODUCTION AND BACKGROUND

On January 20, 2006 (the "Petition Date"), National Gas Distributors, LLC (the "Debtor") filed a voluntary petition seeking relief under Chapter 11 of the Bankruptcy Code. On January 24, 2006, Richard M. Hutson, II, (the "Trustee") was appointed as Chapter 11 Trustee for the Debtor. The Trustee filed this action seeking to avoid the transfers of natural gas made within one year pre-petition on actual or constructive fraud theories under 11 U.S.C. § 548(a)(1)(A) and § 548(a)(1)(B), and to recover from The Smithfield Packing Company, Incorporated ("Defendant")[1] the value of natural gas sold by the Debtor to Defendant in 2005, as represented by the net undercharges after credit for payments made by Defendant to the Debtor, under 11 U.S.C. § 550.

[1] According to the Authentication Declaration of Robert E. Miller, The Smithfield Packing Company, Incorporated and Stadler's Country Hams, Inc., n/k/a The Smithfield Packing Company, Incorporated (together "Smithfield") are wholly owned subsidiaries of Smithfield Foods, Inc.

The Complaint describes in detail how the Debtor, through a calculated and interconnected series of actions taken by its sole member/manager, Paul Lawing, Jr. ("Lawing"), intentionally defrauded its creditors by selling gas to end users such as Defendant at prices below market and in many instances substantially below the cost of the goods sold ("Below Market Sales"). Lawing concealed the Below Market Sales from the Debtor's other sales agents, the Debtor's bookkeeper and creditors of the Debtor, including but not limited to First Citizens Bank and Trust Company ("First Citizens") and Branch Banking & Trust Company ("BB&T").

After making the Below Market Sales, Lawing, on behalf of the Debtor, prepared and booked false invoices for the Below Market Sales as if the sales had been made at market prices, while secretly preparing and delivering a different set of invoices to the customers at the below-market prices. Lawing then caused the Debtor to deliver financial statements to First Citizens and BB&T which reflected the Below Market Sales as if they had been made at market prices. Through this series of actions repeated over the course of 2005, the Debtor was able to borrow funds from First Citizens and BB&T, creditors secured in part by Debtor's accounts receivable, far in excess of the lenders' permitted "borrowing base" and even in excess of the actual value of the accounts pledged as collateral. The Debtor incurred substantial indebtedness which it was unable to pay and used the loan proceeds to continue operations despite heavy losses and while it was insolvent.

As with any Ponzi-type scheme, the Debtor's ability to perpetuate the fraud eventually came to an end, resulting in its collapse in late 2005. Plaintiff contends in the Complaint that the Below Market Sales are avoidable under either § 548(a)(1)(A) or § 548(a)(1)(B), and that the Trustee may recover the difference between the value of the goods sold and the payment made by Defendant to the Debtor pursuant to § 550.

Defendant is one of Lawing's customers and contracted with the Debtor to supply natural gas during the period in question pursuant to a "Base Contract for the Sale of and Purchase of Natural Gas" (the "NAESB Base Contract") promulgated by the North American Energy Standards Board, Inc. The NAESB Base Contract is an industry-standard contract which provides a uniform set of terms and conditions applicable to future sales. This allows the parties to agree upon and confirm individual sale transactions quickly and easily by specifying the particular terms (price, quantity, period of delivery, special payment terms, etc.) by oral communications, confirmed by fax or email.

According to the Authentication Declaration of Robert E. Miller attached as Exhibit B to Defendant's Memorandum (the "Miller Affidavit"), Paul Lawing effectuated and confirmed sales to Defendant via emails in which he would confirm the price of gas for certain periods of varying lengths of time at a "capped" price. Debtor then supplied Natural Gas which Defendant consumed according to its actual requirements. Debtor would then bill Defendant monthly in arrears, applying the rate Lawing had quoted to the volume of gas actually consumed. Defendant does not contend that there were any other agreements between Debtor and Defendant, nor is the Trustee aware of any other agreements.

In the Motions to Dismiss and for Summary Judgment (the "Motion") and supporting memorandum, Defendant contends the contract between the parties was a "swap agreement" as defined in § 101(53B) and as such the transactions are (i) exempt from avoidance claims for constructive fraud under § 548(a)(1)(B) because of the safe harbor provisions of § 546(g) and (ii) exempt from avoidance claims for actual fraud under § 548(a)(1)(A) due to the presumption of value accorded swap agreements under § 548(d)(2)(D).

II. STANDARD OF REVIEW

Defendant correctly states the general standards the Court should apply on a motion made pursuant to Bankruptcy Rule 7056, which incorporates Rule 56 of the Federal Rules of Civil Procedure. Rule 56(a) provides that a party seeking to recover upon a claim may, at any time after the expiration of twenty (20) days from the commencement of the action, move with or without supporting affidavits for a summary judgment in the party's favor upon all or any part thereof.

Rule 56(c) provides that the judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. *Celotex Corp. v Catrett*, 477 U.S. 317, 324, 106 S. Ct. 2548, 2553, 91 L. Ed. 2d 265, 274 (1986). The Court should resolve conflicts by viewing all facts and inferences to be drawn from the facts in the light most favorable to the non-moving party. *Unites States v. Diebold, Inc.*, 369 U.S. 654, 82 S. Ct. 993 (1962). Summary judgment should not be granted unless the moving party establishes his right to judgment "with such clarity as to leave no room for controversy." *Portis v. Folk Constr. Co.*, 694 F.2d 520, 522 (8th Cir. 1982).

III. ARGUMENT

The Defendant asserts that the Transfers of natural gas by the Debtor to the Defendant, even if made pursuant to an actual intent to defraud creditors or for less than reasonably equivalent value when the Debtor was insolvent, are excepted from the Trustee's avoidance powers because the transfers were made by or to a "swap participant" under or in connection with a "swap agreement" and thus protected by § 546(g). Thus the success or failure of

Defendant's Motion depends entirely upon a determination that the contracts between the parties were swap agreements.

The Trustee will show that while Congress intended to protect the financial markets from the potential impact of avoidance actions on swap agreements and went to great lengths to expand the definitions of swap agreements in an effort to cover the myriad forms swap agreements may take, Congress did not extend the protections afforded swap agreements to physical contracts for the sale and delivery of actual goods which are in question in this case.

1. The Court must first interpret the statute as to the meaning of "swap agreement" according to well established principals of statutory construction.

As is frequently stated by the courts, the first step in statutory interpretation is to look to the plain language or plain meaning of the statute itself. *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 109 S. Ct. 1026 (1989); *Lamie v. U.S. Trustee*, 540 U.S. 526, 124 S. Ct. 1023 (2004). BAPCAP made significant amendments to the section defining a "swap agreement", and there are no reported decisions providing analysis of the changes. Nonetheless, the Court may benefit from first considering the definition as stated before the 2005 amendments, and the court decisions applying this section to various situations.

Code definition, pre-BAPCPA

Before the BAPCAP amendments, the definition of swap agreement listed a number of types of swap agreements then in use, including commodity swaps, and provided a general inclusion for any other similar agreement. A number of courts considered the meaning of the definition when applying the exceptions provided under § 546. In *In re Enron Corp.*, 328 B.R.58, 69-70 (Bankr. S.D.N.Y. 2005), the court stated:

> In *Interbulk v. Louis Dreyfus Corp. (In re Interbulk, Ltd.),* 240 B.R. 195, 201 (Bankr.S.D.N.Y.1999), the court described a swap agreement as a bilateral agreement, frequently between a commercial entity involved with commodities or

subject to interest rate, currency or equity price fluctuations and a financial intermediary, whereby cash payments are exchanged periodically (or a lump sum at termination between the parties based upon changes in the price of the underlying asset or index as determined by an agreed-upon benchmark. *Id.* at 201.

A swap agreement has also been defined as "an agreement between two parties whereby the parties agree to exchange one or more future payments measured by different prices of a commodity, with payments calculated by reference to a notional amount." *Id.* at 201, *citing, Nuts and bolts of Financial Products 1999: Understanding the Evolving World of Capital Market and Investment Management Products,* 1099 PLI Corp 315, 323 1999. In swap agreements, the "'notional' amount provides the basis for calculating payment obligations but does not change hands." *Thrifty Oil Co. v. Bank of Am. Nat'l Trust,* 322 F.3d 1039, 1042 (9th Cir.2003) (defining swap agreement as "a contract between two parties ... to exchange ... cash flows at specified intervals, calculated by reference to an index ... [and basing the payments] on a number of indices including interest rates, currency rates and security or commodity prices").

Thus, at least prior to BAPCPA, the courts and the marketplace understood swap agreements to be financial agreements between parties to exchange a series of cash flows generated by underlying prices or rates. Parties could hedge their financial risk on other (physical) contracts, loans, or similar obligations by entering into a swap based on a hypothetical quantity and the difference between two variables, such as fixed versus floating interest rates or spot versus fixed commodity prices, over one or more periods. At the end of the relevant periods, a settlement payment is made by one party to the other, depending on whether one variable is higher or lower than the other.

Code definition, post-BAPCPA

After BAPCPA, the Code now contains the following nearly incomprehensible definition of swap agreements:

(53B) The term "swap agreement"--

(A) means—

(i) any agreement, including the terms and conditions incorporated by reference in such agreement, which is--

(I) an interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap;
(II) a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange, precious metals, or other commodity agreement;
(III) a currency swap, option, future, or forward agreement;
(IV) an equity index or equity swap, option, future, or forward agreement;
(V) a debt index or debt swap, option, future, or forward agreement;
(VI) a total return, credit spread or credit swap, option, future, or forward agreement;
(VII) a commodity index or a commodity swap, option, future, or forward agreement;
(VIII) a weather swap, option, future, or forward agreement;
(IX) an emissions swap, option, future, or forward agreement; or
(X) an inflation swap, option, future, or forward agreement;

(ii) any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that--
(I) is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other derivatives markets (including terms and conditions incorporated by reference therein); and
(II) is a forward, swap, future, option, or spot transaction on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value;

(iii) any combination of agreements or transactions referred to in this subparagraph;

(iv) any option to enter into an agreement or transaction referred to in this subparagraph;

(v) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), or (iv), together with all supplements to any such master agreement, and without regard to whether the master agreement contains an agreement or transaction that is not a swap agreement under this paragraph, except that the master agreement shall be considered to be a swap agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (i), (ii), (iii), or (iv); or

(vi) any security agreement or arrangement or other credit enhancement related to any agreements or transactions referred to in clause (i) through (v), including any guarantee or reimbursement obligation by or to a swap participant or financial participant in connection with any agreement or transaction referred to in any

> such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562; and
>
> **(B)** is applicable for purposes of this title only, and shall not be construed or applied so as to challenge or affect the characterization, definition, or treatment of any swap agreement under any other statute, regulation, or rule, including the Gramm-Leach-Bliley Act, the Legal Certainty for Bank Products Act of 2000, the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934) and the Commodity Exchange Act.

The complexity of the amended definition reflects an attempt to expand protection from bankruptcy intervention to all swap transactions, both those currently known to exist and unknown future variations, by adding to the definition a catch all for all swap transactions which have been, are now or may in the future become the subject of recurring dealings in swap and derivatives markets. As a result, swap agreements are now defined in § 101(53B) as those transactions that (i) fall squarely within one of the specific transactions listed within the definition or similar agreements or transactions, and (ii) are of a type that is presently or in the future becomes the subject of recurrent dealings in the swaps or other derivatives markets, and (iii) are a forward , swap, future, option or spot transaction **on one or more rates, currencies, commodities** etc. (Emphasis added). *see,* <u>Insulating Markets from Bankrupt Debtors and Bankruptcy Judges</u>, 13 Am. Bankr. Inst. L. Rev. 641, 651 (2005).

Unfortunately, this and other relevant Code sections are convoluted and the maze of definitions are difficult to follow, complicated by the fact that many of the terms used in the definition of swap agreement are themselves not defined anywhere in the Code. In order to understand and properly apply the meaning of “swap agreements” the Court must look to the legislative history of the recent amendments, the meaning the terms are afforded in the marketplace, and other publications which provide additional guidance.

Legislative history

Defendant argues that the supply agreement between the Debtor and Defendant falls within the broad definition of a swap agreement. However, the legislative history of both the 1990 and 2005 amendments to the Code indicate that Congress did not intend that its broad definitions of forward contracts should include normal purchases and sales, or that swap agreements should include normal supply agreements, regardless of how the supply agreements may be labeled in the parties' documentation.

> This amendment is intended to clarify that [the exemptions in the Code] apply to genuine forward contracts regarding a commodity . . . but that the exemptions do not apply to ordinary supply-of-goods contracts which are not essentially financial in character. H.R. REP. NO. 101-484, at 6 (1990).
>
> Traditional commercial arrangements, such as supply agreements, or other non-financial market transactions, such as commercial, residential or consumer loans, cannot be treated as "swaps" under the FDIA, the FCUA, or the Bankruptcy Code simply because the parties purport to document or label the transactions as "swap agreements". H.R. REP. 109-31(I), at 121 (2005).
>
> The netting of cash flows which is "at the center of the swap agreement" provides the rationale for exempting swap agreements from the Code's automatic stay and avoidance provisions in order to protect the markets in which the instruments are traded from "uncertainties regarding the treatment of their financial instruments under the Bankruptcy Code" and to avoid impairing the ability of participants to resolve transactions "promptly and with finality" to protect themselves from heavy losses. H.R. REP. NO. 101-484, at 1-2 (1990).
>
> Under the "avoidance" provisions a fund transfer from the debtor to the other party might be "avoidable" by the trustee while the transfer from the other party to the debtor would not be. H.R. REP. NO. 101-484, at 3 (1990).

Thus, Congress sought to protect financial markets from the impact of bankruptcy avoidance actions, but did not intend to extend this shelter to ordinary commercial transactions for the sale of goods. This distinction is consistent with the balancing of competing policy concerns reflected throughout the legislative history and reported decisions where it is clear

Congress sought to insulate financial markets from the financial collapse of any individual participant without interfering in simple sales of commodities.

EIA Report

The Energy Information Administration of the United States Department of Energy in its release entitled "Derivatives and Risk Management in the Petroleum, Natural Gas, and Electricity Industries (October 2002)" (the "EIA Report") defines a swap as "an agreement between two parties to exchange a series of cash flows generated by underlying assets. No physical commodity is actually transferred between the buyer and seller."[2]

In that same publication, the Energy Information Administration provides the following example of a swap transaction.

> . . . a refiner and an oil producer agree to enter into a 10-year crude oil swap with a monthly exchange of payments. The refiner (Party A) agrees to pay the producer (Party B) a fixed price of $25 per barrel, and the producer agrees to pay the refiner the settlement price of a futures contract for NYMEX light, sweet crude oil on the final day of trading for the contract. The notional amount of the contract is 10,000 barrels. Under this contract the payments are netted, so that the party owing the larger payment for the month makes a net payment to the party owing the lesser amount. If the NYMEX settlement price on the final day of trading is $23 per barrel, Party A will make a payment of $2 per barrel times 10,000, or $20,000, to Party B. If the NYMEX price is $28 per barrel, Party B will make a payment of $30,000 to Party A. The 10-year swap effectively creates a package of 120 cash-settled forward contracts, one maturing each month for 10 years.
>
> So long as both parties in the example are able to buy and sell crude oil at the variable NYMEX settlement price, the swap guarantees a fixed price of $25 per barrel, because the producer and the refiner can combine their financial swap with physical sales and purchases in the spot market in quantities that match the nominal contract size. All that remains after the purchases and sales . . . cancel each other out are the fixed payment of money to the producer and the refiner's purchase of crude oil. The producer never actually delivers crude oil to the refiner, nor does the refiner directly buy crude oil from the producer. All their physical purchases and sales are in the spot market, at the NYMEX price.

[2] http://www.eia.doe.gov/oiaf/servicerpt/derivative/index.html

> Many of the benefits associated with swap contracts are similar to those associated with futures or options contracts. That is, they allow users to manage price exposure risk without having to take possession of the commodity.[3]

Applying the foregoing example of a swap transaction from the EIA Report to a hypothetical avoidance action under § 548, Party A and Party B enter into a financial contract to allocate the risk of market fluctuations for crude oil, and at the end of the relevant period either Party A must pay $20,000 to Party B if the market price has fallen to $23 per barrel, or Party B must pay $30,000 to Party A if the market price has risen $28 per barrel. It is now clear because of the definition of swap agreements and §546(g) that if the party making the payment subsequently files for bankruptcy protection, the trustee may no longer assert that the payment is avoidable on the basis that no value was realized by the estate as no goods were delivered to the debtor in return for the payment.

It is important to note that the example used by the Department of Energy also explains the practical use and benefit of the swap agreement, as each party "can combine their financial swap with physical sales and purchase in the spot market in quantities that match the nominal contract size." The distinction is clear that the swap agreements are financial transactions designed and intended to enhance the parties' physical contracts, which in turn represent the actual sale and delivery of the commodities. The participants in the swap agreements exchange only a settlement payment not the underlying goods.

FAS 133

In addition to the legislative history and the EIA Report, the Court may consider the standards adopted by the Financial Accounting Standards Board[4] with respect to reporting

[3] Id.
[4] Financial Accounting Standards Board Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, June 1998.

derivatives, Statement of Financial Accounting Standards No. 133 (“FAS 133”). This standard requires that companies recognize all derivatives as assets or liabilities in their statements of financial position at fair value, and the text of FAS 133 aids in understanding the “on one or more underlying rates or prices” requirement. It defines a derivative as a “financial instrument or other contract” with three characteristics:

(a) it specifies one or more underlying rates or prices and one or more notional amounts[5]; and,

(b) it requires minimal or no initial net investment; and,

(c) it requires or permits net settlement.

The “underlying” rate or price is “a specified interest rate, security price, foreign exchange rate, index prices or rates or other variable.” Underlyings may be the price of an asset but not the asset itself. FAS 133 § 7.

FAS 133 § 10(b) recognizes that its definition of a derivative is broad and creates an exception from the reporting requirement for transactions that might otherwise fall within the definition of a derivative when entered into as normal purchases and sales of items (other than financial instruments) which are used or sold by the reporting company in a reasonable time in the normal course of business. Under FAS 133, a “normal purchase or sale” is defined as “A contract that provides for the purchase or sale of something (other than a financial instrument or derivative instrument) that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business, and likely to result in the physical delivery of goods.” FAS 133 § 12(b).

[5] A notional amount is the quantity of currency units, shares or other units specified in the contract.

Gotham Affidavit

Physical contracts are distinctly different from swap agreements. Physical contracts involve the sale and delivery of goods by the seller and the corresponding payment of the purchase price by the purchaser. Swap agreements involve the purchase or sale of financial instruments or derivative instruments and provide for an exchange of cash flows and an ultimate net "settlement" between the parties. In a swap transaction one party "swaps" one type of risk, such as one dependent on a fixed price, for another type of risk, such as one dependent on a floating price. The floating price is usually tied to a market-based indicator, such as an index price. The other party takes on the opposite risk. The parties then exchange (swap) a set of payments dependent on the difference between the two cash flows generated by the different risks at specified, agreed upon intervals. No physical commodity is exchanged. Gotham Affidavit, ¶ 8. A physical contract in contrast is never "settled" to adjust for risk or market fluctuations, and a swap agreement is never settled by the delivery or exchange of goods. Gotham Affidavit, ¶ 9.

Defendant's contention that the contract between the parties is a forward contract and *ipso facto* a swap agreement misses the true definitional requirement of § 101(53B)(A)(ii)(II) that a swap be a contract based on one or more underlying rates or prices. It is the interaction of the underlying rates or prices which produces the net settlement characteristic of swaps. Regardless of whether a physical contract may be labeled as or considered to be a forward contract, the underlying characteristics of the transaction will determine whether the market considers the arrangement to be a swap agreement. A physical contract lacks the essential elements of a swap agreement in that a physical contract is not a purely financial arrangement

between parties participating in a financial market. Thus, a forward contract in and of itself is not a swap agreement if the true characteristics of a swap are lacking. Gotham Affidavit, ¶ 10.

Contrasting swap and forward agreements

The fundamental error in Defendant's analysis is its contention that the agreements for the delivery of natural gas were "forward contracts" between the Debtor and Defendant, and that forward contracts necessarily constitute "swap agreements" when in fact, the contractual arrangement at issue here is nothing more than a series of agreements between a supplier and an end user for the purchase of a commodity to be delivered at an agreed upon price in the future. The agreements may or may not be forward contracts but are certainly not swap agreements.

As the Trustee's expert energy consultant notes in her affidavit, the marketplace recognizes a distinction between physical contracts for the purchase of goods and financial contracts. Physical contracts are documented using the NAESB Base Contract which the Debtor and Defendant used in this case, while financial contracts are documented using use the 2002 Master Agreement prescribed by the International Swaps and Derivatives Association (ISDA). Gotham Affidavit, ¶¶ 4-7. Ms. Gotham goes on to observe that a forward contract for the physical purchase of goods is not a swap if the financial characteristics of a swap agreement are missing, and that she knows of no market that would recognize the contract between the parties in the present case as a swap. Gotham Affidavit, ¶¶ 10, 13.

Consistent with this distinction, Defendant did not report its contracts with Debtor as derivatives in the Statement of Financial Position it filed with the financial statements it filed with its Form 10K with the Securities and Exchange Commission for 2005.[6] Gotham Affidavit, ¶ 12. In fact, Defendant reported in its discussion of Derivatives and Other Hedging in Note 29 to its financial statement that "In January 2004, the company terminated its broad-based foreign

[6] http://media.corporate-ir.net/media_files/irol/73/73320/DuPont2006Form10K.pdf

currency revenue hedging program, as well as its programs to hedge natural gas purchases." Defendant presumably recognized the need to report its derivative and hedging activities, and Defendant's failure to mention the contracts with Debtor in its 10K is consistent with the fact that they are not derivatives but simply contracts for the supply of goods, nothing more or less.

Indeed, had the Defendant desired to hedge its supply agreement with the Debtor, the Defendant could have done so by entering into a swap agreement with a third party or by taking advantage of the financial markets which offer this product. As set forth in the affidavit of the Trustee's expert:

> Many market participants use the Intercontinental Exchange ("ICE") as a method for price discovery and/or trading exchange for energy transactions. ICE operates an electronic marketplace for trading both futures and OTC energy contracts. ICE offers OTC market participants a selection of derivative contracts, as well as contracts for physical delivery of commodities. The types of OTC products available for trading in ICE's markets include forwards and swaps. ICE offers a range of OTC contracts based on crude oil and refined products, natural gas, power and emissions. ICE specifically lists swaps contracts for the following commodities: global oil, North American power, North American gas, UK gas and UK power. On the physical natural gas side, ICE offers hundreds of products for trade, varying by delivery point, term, etc. ICE clearly delineates and separates contracts/products that settle through physical delivery from those that are cash-settled. These are not considered by the marketplace to be the same thing, or subsets of the same thing. Gotham Affidavit, ¶ 10.

Put simply, an agreement for the sale of goods, standing alone, does not constitute a swap transaction, as there is no matching agreement with differing characteristics.

Sections 546(e) and 546(g)

The distinction between forward contracts for the physical sale of natural gas and swap agreements for the financial hedging of such transactions is critical when applied to the contracts at issue here as the protections afforded parties to forward contracts by § 546(e) are more limited than the protections afforded parties to swap agreements by § 546(g). If the contractual arrangements between the Debtor and Defendant are simply sale or supply agreements which

may be forward contracts but not swap agreements, § 546(e) provides no relief to the Defendant and § 546(g) is inapplicable.

Under § 546(e) the trustee is only prevented from avoiding a transfer that is a "settlement payment" made by or to a forward contract merchant, while under § 546(g) the trustee is prevented from avoiding any transfer that is made by or to a swap participant under or in connections with a swap agreement. The Transfers which the Trustee seeks to avoid in the present case are the Debtor's sale and delivery of natural gas, not payments. Thus, the Defendant may not take advantage of § 546(e) to protect the transfer of natural gas at a below-market price and must instead characterize the transaction as a swap agreement in order to take advantage of § 546(g).

Defendant's memorandum correctly states that the purpose of § 546(e) and (g) and other sections is to protect certain transactions in and affecting financial markets. However, Defendant goes on to blur the line between the limited protections afforded to forward contracts under § 546(e) and the broader protections afforded to swap agreements under § 546(g) in part by contending that the forward contracts are by definition swap agreements. If this were true, there would be no reason for the separate treatment afforded forward contracts and swap agreements and § 546(e) would be superfluous.

Each of the two cases cited for the proposition that the safe harbor provisions of § 546(g) apply to the transaction in this case arise from distinctly different factual situations in which the court applied § 546(e) to bar avoidance actions seeking to recover settlement payments, not § 546(g). In each of those cases, the contract in question was financial in nature as opposed to a physical contract for the sale and delivery of goods, and involved either the net settlements or the financial participants Congress undertook to protect from the Trustee's avoidance powers.

In *Williams v. Morgan Stanley Capital Group Inc. (In re Olympic Natural Gas Co.)*, 294 F.3d 737 (5th Cir. 2002), neither of the parties was an end user of natural gas. Instead the parties had a contract calling for them to buy and sell gas to and from each other in numerous transactions with a net settlement at the end of the month. The Court held that the payments were "settlement payments" under 101(51A) and could not be avoided as preferences by reason of the exception provided by 546(e). The arguments in that case turned on an issue (whether "forward contract" included purchase and sale contracts, as opposed to futures or on-exchange financial instruments and forwards or off-exchange financial instruments) which has no relevance to the present dispute. The Court did not discuss swap agreements or the application of § 546(g) in the decision.

However, in deciding the pivotal issue the court declined to adopt an interpretation of one definition in the Code which would conflict with another definition set out elsewhere in the Code. *Id.*, at p. 741, citing *United States Nat'l Bank of Oregon v. Indep. Ins. Agents of America, Inc.*, 508 U.S. 439, 460, 113 S. Ct. 2173 (1993). The Court noted that "…courts in other circuits have repeatedly stated that one of the distinguishing characteristics of a forward contract is that the parties expect to make actual delivery." *Id*., at p. 741 (citations omitted). Thus, the *Olympic Natural Gas* decision is more useful to this Court for the propositions that (i) portions of a statute should be construed or interpreted in a manner which does not create internal conflicts, and (ii) forward contracts can be identified by the component of the parties to the agreement making an actual delivery of the goods, as opposed to purely financial in nature.

Similarly, in *BCP Liquidating LLC v. Bridgeline Gas Marketing, LLC (In re Borden Chemicals and Plastics Operating Ltd. Partnership)*, 336 B.R.214 (Bankr. D. Del. (2006) the Court determined that the payments at issue were settlement payments under a forward contract

and thus exempt from preference claims. The parties had entered into a physical contract for the delivery of natural gas, the liquidating trust sought to avoid and recover a settlement payment, and the Court applied § 546(e). In that decision, the Court considered whether a contract for the sale and delivery of goods was effectively a "hedge" against future price fluctuations and thus financial and risk-shifting in nature, and if so whether a hedge would be included within the definition of a forward contract. The Court found that a forward contract may have both physical and financial characteristics. *Id.*, at p. 221. More notably, however, the Court did <u>not</u> consider or suggest the possibility that the contract at issue could be not only a forward contract but also a swap agreement. Instead, the Court relied heavily upon the EIA Report to describe the use of forward contracts as a physical hedge against price, and noted that "… within the commodities market there is a continuum of transactions from spot to forward to swaps and options to futures." *Id.*, at p. 222-223. If the Court had equated forward contracts with swap agreements, the Court could have simply ended the analysis at that point as § 546(g) protects <u>all</u> transfers to or from a swap participant. Instead, the Court found that the agreement was a forward contract and then went on to determine whether the relevant transfer was a "settlement payment" protected by § 546(e).

<u>Commentary</u>

Finally, faced with an absence of reported decisions that hold a forward contract to be a swap agreement, Defendant relies on <u>Insulating Markets from Bankrupt Debtors and Bankruptcy Judges</u>, 13 Am. Bankr. Inst. L. Rev. 641 (2005) where the authors argue that the most recent amendments to the Code are so expansive and all-encompassing that entire financial markets are exempted from scrutiny and that the definition of swap agreement covers all derivatives including forward contracts. This argument disregards the fact that it would render §

546(e) meaningless and runs counter to the . . . "cardinal principle of statutory construction" that "a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant." *TRW Inc. v. Andrews*, 534 U.S. 19 at 31, 122 S.Ct. 441 at 449 (2001).

If every forward contract is a swap agreement, then why make the distinction made between the limited protections afforded parties to a forward contract in § 546(e) and the broader protections afforded to parties to a swap agreement in § 546(g)? Why does the definition of swap agreement include a reference to "forward agreements" rather than to "forward contracts" when the latter term is defined and used elsewhere in the Code? Most importantly, how does the interpretation that forward contracts are one and the same with swap agreements comport with how these terms are used in the marketplace, particularly when § 101(53B) indicates that agreements are swap agreements when so defined in the marketplace?

In the article cited above, the authors acknowledge early on that "The Code's definitions are based exclusively on *market* definitions." *Id*., at p. 643. "The definition of "swap agreement," for example, became a part of the Code in 1990 and set out a non-exhaustive list of swap-like transactions—rate, basis, commodity, currency, and cross-currency rate swaps; interest rate and currency options; rate caps, floors, and collars; and 'any other similar agreement.' None of these transactions was defined by the Code; a judge was presumably expected to rely on standard market definitions." *Id.*, at p. 646.

The authors go too far when they suggest that the new definition for swap agreements covers all the stated transactions, plus options, forwards, and futures involving the same subject matter, as the market place does not so define swap agreements. Instead, as stated above and confirmed in the EIA Report, FAS 133 and the Gotham Affidavit, swap agreements have their

own particular characteristics, essential features of which are lacking in the contractual arrangements between the Debtor and Defendant.

Assume an insolvent hog farmer agrees to sell ten hogs to a good faith purchaser for a fixed price per pound, with delivery to be made a week later. At the same time, the purchaser enters into a swap agreement with a third party to hedge the price of hogs based on the difference between the fixed price and a variable price in the financial markets. Upon filing of the hog farmer's bankruptcy petition, the hog sale is subject to potential avoidance if the farmer sold the hogs at a price which is less than reasonably equivalent value such that the trustee might recover the difference between the sale price and fair value for the hogs from the purchaser. Such an avoidance action will have no effect on the swap transaction whatsoever, and the impact on the purchaser is simply that he has to pay fair value for the goods purchased.

Under Defendant's view, the farmer's sale of ten hogs is a forward contract and therefore a swap agreement protected from any potential avoidance actions or other limitations. This strained interpretation is without foundation from a policy perspective and simply cannot be correct.

IV. CONCLUSION

The answers to these questions are clear: the statute must be interpreted to give each of its parts a logical and reasonable application, and the marketplace considers forward contracts and swap agreements to be separate and distinct. The agreements at issue between the Debtor and Defendant may indeed be forward contracts, if the essential components of a forward contract can be established, but that conclusion would not make these agreements swap agreements and the protections of § 546(g) are simply inapplicable.

There is simply no basis for the Court to hold that the agreements between the Debtor and Defendant were swap agreements. Absent such a holding, the Transfers are subject to avoidance and are not excepted by § 546(g), the parties to the agreements are not swap participants, and the "value" provisions of § 548(d)(2)(D) are inapplicable. For this reason alone, the Motion should be denied.

RESPECTFULLY submitted on behalf of the Trustee, this the 15th day of March, 2007.

/s/ John A. Northen
Counsel for the Trustee

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Chapel Hill, NC 27515-2208
Telephone: 919-968-4441
Telefax: 919-942-6603

CERTIFICATE OF SERVICE

THIS IS TO CERTIFY that on the below date, the undersigned served a copy of the foregoing electronically and/or by depositing the same, enclosed in a post paid wrapper, properly addressed to the following parties in interest, at their last known addresses as shown below, in a post office or official depository under the exclusive care and custody of the United States Postal Service:

Thomas E. Cabaniss
Robert A. Cox, Jr.
McGuire Woods LLP
100 N. Tryon St., Ste 2900
Charlotte, NC 28202

This the 15th day of March, 2007.

By: /s/ John A. Northen
Counsel for the Trustee

NORTHEN BLUE, L.L.P.
John A. Northen, NCSB #6789
Vicki L. Parrott, NCSB #25762
PO Box 2208
1414 Raleigh Rd., Ste 435 (27517)
Chapel Hill, NC 27515-2208
Telephone: 919-968-4441
Telefax: 919-942-6603

Affidavit of Claire P. Gotham

Claire P. Gotham, being first duly sworn, disposes and says:

1 Pursuant to an order of the Court dated February 13, 2007, Richard M. Hutson, II (the "Trustee"), Chapter 11 Trustee for Natural Gas Distributors, LLC (the "Debtor") in Case No. 06-00166-8-ATS now pending in the U.S. Bankruptcy Court for the Eastern District of North Carolina, employed Claire P. Gotham and the firm of GSC Energy, Inc. to provide expert testimony and litigation support.

2 My resume setting out my background and experience in the energy industry is attached hereto as Exhibit 1. Based upon my specialized knowledge, skill, experience, training and education involving the natural gas industry as summarized in my resume, and after applying my experience to the matters discussed in this affidavit, I believe that I have a sufficient basis to form the opinions set forth below.

3 In developing the opinions set forth in this Affidavit, I have reviewed the following:

a. Authentication Declaration of Robert E. Miller (the "Miller Affidavit") and supporting exhibits attached (i) as Exhibit B to the memorandum in support of the Motions to Dismiss and for Summary Judgment filed by Smithfield Packing Company ("Smithfield") in AP No. 06-00267-8-ATS, and (ii) as Exhibit B to the memorandum in support of the Motions to Dismiss and for Summary Judgment filed by Stadler's Country Hams, Inc. ("Stadler") in AP No. 06-00266-8-ATS.

b. Authentication Declaration of David J. Maier (the "Maier Affidavit") and supporting exhibits attached as Exhibit B to the memorandum in support of the Motions to Dismiss and for Summary Judgment filed by E.I. Du Pont De Nemours and Company's ("Dupont") in AP No. 06-00268-8-ATS.

c. North American Energy Standards Board, Inc. ("NAESB") Base Contract for Sale and Purchase of Natural Gas, NAESB Standard 6.3.1 dated April 19, 2002 (the "NAESB Base Contract"), as used by the Debtor and the Defendant and a copy of which is attached to the Miller Affidavit and the Maier Affidavit.

d. International Swaps and Derivatives Association ("ISDA") 2002 Master Agreement.

e. Financial Accounting Standards Board Statement No. 133 as amended and interpreted, "Accounting for Derivative Instruments and Hedging Activities" ("FAS 133").

f. 2005 Forms 10K filed by Smithfield and Dupont with the Securities and Exchange Commission, relevant portions of which as discussed below are attached hereto as <u>Exhibits 2 and 3</u>, respectively.

4 The transactions described in the Miller Affidavit and the Maier Affidavit are contracts for the purchase and sale of a physical commodity (sometimes referred to as "physical contracts") and reflect an agreement between two parties for the actual delivery by a seller (the Debtor) to a purchaser (Smithfield, Stadler or Dupont) as an end-user of the commodity (natural gas). Transactions involving the physical transfer of a commodity are typically documented by use of the NAESB Base Contract, which is the industry-standard contract document for physical contracts prescribed by the North American Energy Standards Board, Inc.

5 The NAESB Base Contract provides an agreed set of terms and conditions which will apply to subsequent physical contracts for the sale of natural gas as and when the parties may agree to one or more transactions. The NAESB Base Contract was in fact used by the Debtor in its transactions with Smithfield, Stadler and Dupont, and the particular transactions involved

reflect a series of sales and deliveries of physical goods over the period in question, as set forth in the Miller Affidavit and the Maier Affidavit.

6 Swap agreements are "financial instruments (contracts) that do not represent ownership rights in any asset but, rather, derive their value from the value of some other underlying commodity or other asset."[1] The Financial Accounting Standards Board defines a derivative as: "A financial instrument or other contract" with all three of the following characteristics:

a. it has one or more underlyings and one or more notional amounts or payment provisions or both
b. it requires no initial net investment (or practically none)
c. its terms require or permit net settlement [2]

7 Unlike the transactions involving the physical transfer of a commodity where the NAESB Base Contract was used by Debtor and the other parties, swap participants typically use the 2002 Master Agreement prescribed by the International Swaps and Derivatives Association (ISDA) for their contract documentation.

8 Physical contracts are distinctly different from swap agreements, also known as derivatives, which involve the purchase or sale of financial instruments or derivative instruments and provide for an exchange of cash flows with differing characteristics and an ultimate net "settlement" between the parties. While physical contracts involve the sale and delivery of goods by the seller and the corresponding payment of the purchase price by the purchaser, swap agreements involve the exchange of similar but differing obligations followed by a settlement payment from one party to the other. For example, in a swap transaction one party could "swap" one type of risk such as one dependent on a fixed price for another type of risk such as one dependent on a floating price. That floating price is usually tied to a market-based indicator, such

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[1] http://www.eia.doe.gov/oiaf/servicerpt/derivative/index.html

[2] FASB Statement No. 133 as amended and interpreted, "Accounting for Derivative Instruments and Hedging Activities"

as an index price. The other party takes on the opposite risk. The parties then exchange (swap) a set of payments dependent on the difference between the two cash flows generated by the different risks at specified, agreed upon intervals. No physical commodity is exchanged.

9 By way of contrast, a physical contract is never "settled" to adjust for risk or market fluctuations, and a swap agreement is never settled by the delivery or exchange of goods.

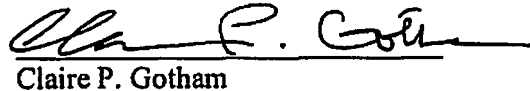
10 Regardless of whether a physical contract may be labeled as or considered to be a forward contract, the underlying characteristics of the transaction will determine whether the market considers the arrangement to be a swap agreement. A physical contract lacks the essential elements of a swap agreement, in that a physical contract is not a purely financial arrangement between two financial contract parties participating in a financial market. Thus, a forward contract in and of itself is not a swap agreement if the true characteristics of a swap are lacking.

11 Many market participants use the Intercontinental Exchange ("ICE") as a method for price discovery and/or trading exchange for energy transactions. ICE operates an electronic marketplace for trading both futures and OTC energy contracts. ICE offers OTC market participants a selection of derivative contracts, as well as contracts for physical delivery of commodities. The types of OTC products available for trading in ICE's markets include forwards and swaps. ICE offers a range of OTC contracts based on crude oil and refined products, natural gas, power and emissions. ICE specifically lists swaps contracts for the following commodities: global oil, North American power, North American gas, UK gas and UK power. On the physical natural gas side, ICE offers hundreds of products for trade, varying by delivery point, term, etc. ICE clearly delineates and separates contracts/products that settle through physical delivery from those that are cash-settled. These are not considered by the marketplace to be the same thing, or subsets of the same thing.

12 The Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 133[3] ("FAS 133") requires that a reporting entity recognize all derivatives measured at fair value as either assets or liabilities in its statement of financial position unless the derivative meets certain exceptions including one for normal purchases and sales. I have reviewed the statement of financial position and accompanying notes contained in the financial statements filed with the 2005 Form 10K filed by Smithfield[4] and Dupont with the Securities and Exchange Commission. Neither of these parties recognized the transactions that are the subject of this litigation as derivatives in their statements of financial position.

13 I am not aware of any market that would recognize the transactions described in the Miller Affidavit and the Maier Affidavit as swap agreements, and in my opinion the transactions are not swap agreements.

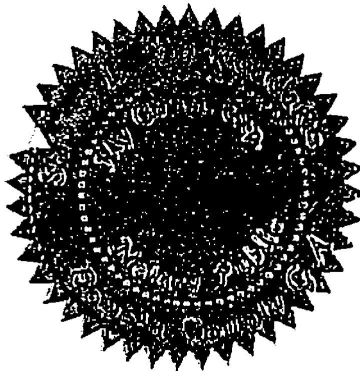
This the 13th day of March 2007.



Claire P. Gotham

Sworn to and subscribed before me this the 13th day of March 2007.

Notary Public
My Commission Expires: 2-1-09



[3] FASB Statement No. 133 as amended and interpreted, "Accounting for Derivative Instruments and Hedging Activities"
[4] According to the answer filed by Stadler in the adversary proceeding, Stadler is now a subsidiary of Smithfield.

EXHIBIT 1

Resume of Claire P. Gotham

EXHIBIT 1 TO AFFIDAVIT

Claire P. Gotham

GSC Energy, Inc.
(404) 889-0652
Claire@hedger.com

HIGHLIGHTS

- Experience in multiple areas of energy industry, including retail end-users, utilities, & wholesale trading
- Extensive skills & experience in client relations, negotiations, & account management
- Recognized speaker, with proven experience in leading large seminars on energy-related issues

Relevant Professional Experience

GSC Energy, Inc., Atlanta, GA — **05/06 to Present**

President

- Oversee all day to day duties involved in developing & managing consulting business
- Develop and execute marketing plan for new business lines
- Teach energy risk management seminars across the country including:
    - *FAS 133 Derivative & Hedge Accounting*
    - *Natural Gas Hedging 101*
    - *Advanced Natural Gas Hedging and Deal Structure*
- Develop service offerings and perform market research

Deloitte & Touche, Los Angeles, CA — **09/05 – 05/06**

Senior Consultant

- Performed various duties as a subject matter expert in the following areas:
    - Risk analysis and management concepts and practices
    - Internal controls related to the trade life cycle (including front, middle, and back office functions)
    - Specific deregulated regional energy markets
    - Regulatory issues affecting deregulated wholesale energy markets
    - Fundamental analysis of physical energy markets
- Developed service offerings and performed market research
- Reviewed and analyzed clients risk management policies and procedures

Independent Consultant, Los Angeles, CA — **06/02 to 09/05**

- Development & execution of risk management strategies, such as physical or financial hedges
- Analysis of energy market fundamentals & current events
- Provide current & forward pricing for various natural gas markets, at both citygates & burnertips
- Trading of natural gas, both physical & financial
- Review, validate & update current energy information infrastructure
- Manage all operational issues, from physical flow to contract negotiations

PacifiCorp Power Marketing, Portland, OR **06/01 to 06/02**
Lead/Senior Gas Trader

- Developed & executed monthly trading strategy around company's fuel supply requirements for generation projects
- Managed strategy daily by monitoring market activity, risk management system reports, & power-trading
- Participated in the development of intermediate & long-term fuel supply strategies
- Executed gas trades for all spark spread transactions, both speculative & for asset management
- Executed trades for proprietary trading book, with company set profit goals & stop losses
- Continuously monitored market for capacity opportunities, forward basis markets for spread & basis hedging opportunities, & the NYMEX for price hedging opportunities
- Reported daily to entire trading group on EIA/AGA storage developments & market impact
- Monitored & evaluated all regulatory proceedings & rulings, & advised on business impact

Sempra Energy Solutions, Los Angeles, CA **10/99 to 1/01**
Natural Gas Portfolio Manager

- Developed portfolio strategy of natural gas supply & delivery for 200+ industrial/commercial retail accounts
- Negotiated pricing & supply agreements for term & immediate supply needs
- Hedged transactions to lock in margins & to manage price risk, utilizing derivatives
- Managed imbalances through trading & storage on six separate delivery systems in the West, core & non-core
- Managed storage injections & withdrawals to maximize operational flexibility & capture seasonal price variations
- Developed & implemented strategy for product design & pricing which allowed company to earn margin & offer competitive products while minimizing risk
- Executed daily to multi-year energy usage forecasts for retail customers
- Generated offers for fixed prices, caps, floors, collars, & index based pricing for national sales force
- Created & authored daily e-newsletters to customers, detailing prices, market outlook & recommendations

Cook Inlet Energy Supply, Los Angeles, CA **9/98 to 10/99**
Manager, Transportation & Exchange

- Traded physical & financial natural gas in Canada, the Pacific Northwest, California, & Rockies, including futures, swaps, & options
- Purchased/Sold spot natural gas to maximize monthly positions & to increase revenue
- Negotiated pricing with other marketing firms & financial brokers for long term deals
- Supervised scheduling, nominating, dispatching gas on a daily & intra-day basis, resolving allocations & imbalances
- Researched & recommended strategy regarding natural gas storage/transportation projects, & regulatory issues
- Acquired & coordinated the acquisition of gas transportation, including released capacity
- Composed & presented transportation & storage analysis for potential buyers, during corporate sale process
- Represented CIES as a speaker at energy industry trade shows, customer meetings, & conferences

Pacific Gas & Electric Company, San Francisco, CA **9/96 – 9/98**

Product Management/ Product Development

- Responsible for all parts of product process: concept development, program policies, market introduction, product management, & contract negotiation
- Led cross-functional teams to create & launch new products, with operational, financial, regulatory considerations
- Developed product enhancements based on market knowledge, customer segmentation, & market research
- Planned & led all sales force training for new or upgraded products
- Organized & executed customer focus groups in various cities

Sales & Service

- Negotiated & executed short/long term storage, hub services & transportation deals for California pipeline
- Developed pricing decisions through understanding of market issues & identification of financial opportunities
- Researched these opportunities, as well as competitive options & provided analysis to department heads
- Gathered, managed, & communicated market intelligence throughout department via E-mail & Lotus Notes database
- Coordinated sales activities with Product Management & Market Relations to ensure sales goals were achieved

GSC Energy, Atlanta, GA **8/94 - 8/96**

Energy Futures Trader

- Obtained Series 3 license & registration with the NFA & the CFTC
- Order execution of NYMEX energy futures contracts
- Assisted with the development of risk management & hedge programs for clients, utilizing various derivatives
- Researched & evaluated current data regarding risk management incentive mechanisms utilized by public utilities
- Created & implemented new marketing strategies for GSC Energy daily publications
- Qualified & pursued sales leads for consulting group generated by risk management workshops held across the U.S. & Canada

EDUCATION & QUALIFICATIONS

Bachelor of Arts in Anthropology & Spanish, ***Cum Laude*** TULANE UNIVERSITY, New Orleans, LA

Fluency in Spanish

EXHIBIT 2

Note 8 to Smithfield 2005 Consolidated Financial Statements

$90.00 subject to adjustment. Each Preferred Share will entitle its holder to 2,000 votes and will have an aggregate dividend rate of 2,000 times the amount, if any, paid to holders of common stock. The Rights will expire on May 31, 2011, unless the date is extended or unless the Rights are earlier redeemed or exchanged at the option of the board of directors for $.00005 per Right. Generally, each share of common stock issued after May 31, 2001 will have one Right attached. The adoption of the Rights Plan has no impact on the financial position or results of operations of the Company.

Stock Held in Trust

During fiscal 2005, the Company's Supplemental Executive Retirement Plan purchased 350,000 shares of Company stock at an average price of $25.40 per share.

Accumulated Other Comprehensive Loss

The table below summarizes the components of accumulated other comprehensive loss, net of tax, as of May 1, 2005 and May 2, 2004.

(in millions)	2005	2004
Minimum pension liability	$(53.4)	$(41.4)
Foreign currency translation	27.4	(0.5)
Hedge accounting	(0.8)	1.7
Unrealized gain on securities	0.1	—
Accumulated other comprehensive loss	$(26.7)	$(40.2)

Note 8: Derivative Financial Instruments

The Company's meat processing and hog production operations use various raw materials, primarily live hogs, live cattle, corn and soybean meal, which are actively traded on commodity exchanges. The Company hedges these commodities when management determines conditions are appropriate to mitigate these price risks. While this hedging may limit the Company's ability to participate in gains from favorable commodity fluctuations, it also tends to reduce the risk of loss from adverse changes in raw material prices. The Company attempts to closely match the commodity contract terms with the hedged item. The Company also enters into interest rate swaps to hedge exposure to changes in interest rates on certain financial instruments and periodically enters into foreign exchange forward contracts to hedge certain of its foreign currency exposure.

Cash Flow Hedges

The Company utilizes derivatives (primarily futures contracts) to manage its exposure to the variability in expected future cash flows attributable to commodity price risk associated with forecasted purchases and sales of live hogs, live cattle, corn and soybean meal. These derivatives have been designated as cash flow hedges.

Derivative gains or losses from these cash flow hedges are deferred in other comprehensive income (loss) and reclassified into earnings in the same period or periods during which the hedged forecasted purchases or sales affect earnings. To match the underlying transaction being hedged, derivative gains or losses associated with anticipated purchases are recognized in cost of sales and amounts associated with anticipated sales are recognized in sales in the consolidated statement of income. Ineffectiveness related to the Company's cash flow hedges was not material in fiscal 2005, 2004 or 2003. There were no derivative gains or losses excluded from the assessment of hedge effectiveness and no hedges were discontinued during fiscal 2005, 2004 or 2003 as a result of it becoming probable that the forecasted transaction would not occur.

Fair Value Hedges

The Company's commodity price risk management strategy also includes derivative transactions (primarily futures contracts) that are designated as fair value hedges. These derivatives are designated as hedges of firm commitments to buy live hogs, live cattle, corn and soybean meal and hedges of live hog inventory. Derivative gains and losses from these fair value hedges are recognized in earnings currently along with the change in fair value of the hedged item attributable to the risk being hedged. Gains and losses related to hedges of firm commitments are recognized in cost of sales in the consolidated statement of income. Ineffectiveness related to the Company's fair value hedges was not material in fiscal 2005, 2004 or 2003. There were no derivative gains or losses excluded from the assessment of hedge effectiveness during fiscal 2005, 2004 or 2003.

Foreign Currency and Interest Rate Derivatives

In accordance with the Company's risk management policy, certain foreign currency and interest rate derivatives were executed in fiscal 2005, 2004 and 2003. These derivative instruments were primarily recorded as cash flow hedges or fair value hedges, as appropriate, and were not material to the results of operations.

The following table provides the fair value gain or (loss) of the Company's open derivative financial instruments as of May 1, 2005 and May 2, 2004.

(In millions)	2005	2004
Livestock	$(1.6)	$(64.8)
Grains	(3.2)	6.3
Interest rates	(5.2)	(6.2)
Foreign currency	(2.0)	(1.2)

As of May 1, 2005, no commodity futures contracts exceed twelve months. As of May 1, 2005, the weighted average maturity of the Company's interest rate and foreign currency financial instruments is twenty months, with maximum maturities of fifty-four and four months, respectively. The Company believes the risk of default or nonperformance on contracts with counterparties is not significant.

The Company determines the fair value of public debt using quoted market prices and values all other debt using discounted cash flow techniques at estimated market prices for similar issues. As of May 1, 2005 and May 2, 2004, the fair value of long-term debt, based on the market value of debt with similar maturities and covenants, was approximately $2,359.6 million and $1,903.0 million, respectively.

Note 9: Pension and Other Retirement Plans

The Company provides the majority of its U.S. employees with pension benefits. Salaried employees are provided benefits based on years of service and average salary levels. Hourly employees are provided benefits of stated amounts for each year of service.

The Company also provides health care and life insurance benefits for certain retired employees. These plans are unfunded and generally pay covered costs reduced by retiree premium contributions, co-payments and deductibles. The Company retains the right to modify or eliminate these benefits. The Company considers disclosures related to these plans immaterial to the consolidated financial statements and notes thereto.

EXHIBIT 3

Note 29 to DuPont 2005 Consolidated Financial Statements

In 2004 the company made contributions of $709 to its pension plans, including a $300 contribution to its principal U.S. pension plan. In 2003, the company contributed $460 to pension plans other than the principal U.S. pension plan. There were no contributions made to the principal U.S. pension plan during 2003.

Estimated Future Benefit Payments

The following benefit payments, which reflect future service, as appropriate, are expected to be paid:

	Pension Benefits	Other Benefits
2006	$1,449	$ 350
2007	1,432	347
2008	1,420	340
2009	1,417	338
2010	1,417	337
Years 2011 – 2015	$7,360	$1,639

Defined Contribution Plan

The company sponsors several defined contribution plans, which cover substantially all U.S. employees. The most significant is The Savings and Investment Plan (the Plan). This Plan includes a non-leveraged Employee Stock Ownership Plan (ESOP). Employees are not required to participate in the ESOP, and those who do are free to diversify out of the ESOP. The purpose of the Plan is to provide additional retirement savings benefits for employees and to provide employees an opportunity to become stockholders of the company. The Plan is a tax qualified contributory profit sharing plan, with cash or deferred arrangement, and any eligible employee of the company may participate. The company will contribute an amount equal to 50 percent of the first 6 percent of the employee's contribution election. The company's contributions to the Plan were $51, $53 and $60 for years ended December 31, 2005, 2004, and 2003, respectively. The company's contributions vest immediately upon contribution to the plan.

29. Derivatives and Other Hedging Instruments

Objectives and Strategies for Holding Derivative Instruments

Under procedures and controls established by the company's Financial Risk Management Framework, the company enters into contractual arrangements (derivatives) in the ordinary course of business to reduce its exposure to foreign currency, interest rate and commodity price risks. The framework has established a variety of approved derivative instruments to be utilized in each risk management program, as well as varying levels of exposure coverage and time horizons based on an assessment of risk factors related to each hedging program. Derivative instruments utilized during the period include forwards, options, futures and swaps. The company has not designated any nonderivatives as hedging instruments.

The framework sets forth senior management's financial risk management philosophy and objectives through a Corporate Financial Risk Management Policy. In addition, it establishes oversight committees and risk management guidelines that authorize the use of specific derivative instruments and further establishes procedures for control and valuation, counterparty credit approval, and routine monitoring and reporting. The counterparties to these contractual arrangements are major financial institutions and major commodity exchanges. The company is exposed to credit loss in the event of nonperformance by these counterparties. The company manages this exposure to credit loss through the aforementioned credit approvals, limits, and monitoring procedures and, to the extent possible, by restricting the period over which unpaid balances are allowed to accumulate. The company does not anticipate nonperformance by counterparties to these contracts, and no material loss

would be expected from such nonperformance. Market and counterparty credit risks associated with these instruments are regularly reported to management.

The company hedges certain business-specific foreign currency exposures as well as foreign currency denominated monetary assets and liabilities. In addition, the company enters into exchange traded agricultural commodity derivatives to hedge exposures relevant to agricultural feedstock purchases.

In January 2004, the company terminated its broad-based foreign currency revenue hedging program, as well as its programs to hedge natural gas purchases. All outstanding foreign currency and natural gas hedging positions related to these contracts expired during 2004. In October 2005, the company re-approved the use of financial derivatives to hedge exposure to price fluctuations for certain energy feedstock purchases. However, at December 31, 2005, the company had not entered into any derivative instruments with respect to this program.

Fair Value Hedges

During the year ended December 31, 2005, the company has maintained a number of interest rate swaps that involve the exchange of fixed for floating rate interest payments that allow the company to maintain a target range of floating rate debt. All interest rate swaps qualify for the shortcut method of hedge accounting, thus there is no ineffectiveness related to these hedges. Changes in the fair value of derivatives that hedge interest rate risk are recorded in Interest expense each period. The offsetting changes in the fair values of the related debt are also recorded in Interest expense. The company maintains no other fair value hedges.

Cash Flow Hedges

The company maintains a number of cash flow hedging programs to reduce risks related to foreign currency and commodity price risk. Foreign currency programs involve hedging a portion of certain foreign currency-denominated raw material purchases from vendors outside of the United States. Commodity price risk management programs serve to reduce exposure to price fluctuations on purchases of inventory such as corn, soybeans, and soybean meal. While each risk management program has a different time horizon, most programs currently do not extend beyond the next two-year period.

Hedges of foreign currency-denominated revenues are reported on the Net sales line of the Consolidated Income Statement, and the effects of hedges of inventory purchases are reported as a component of Cost of goods sold and other operating charges.

Cash flow hedge results are reclassified into earnings during the same period in which the related exposure impacts earnings. Reclassifications are made sooner if it appears that a forecasted transaction will not materialize. Cash flow hedge ineffectiveness reported in earnings for 2005 is a pretax gain of $3. During 2005, there were no pretax gains (losses) excluded from the assessment of hedge effectiveness. The amount reclassified to earnings for forecasted transactions that did not occur was a loss of approximately $32 in 2005 and is recorded in Other income. The following table summarizes the effect of cash flow hedges on Accumulated other comprehensive income (loss) for 2005:

	Pretax	Tax	After-tax
Beginning balance	$ 6	$(2)	$ 4
Additions and revaluations of derivatives designated as cash flow hedges	8	(3)	5
Clearance of hedge results to earnings	(11)	4	(7)
Ending balance	$ 3	$(1)	$ 2
Portion of ending balance expected to be reclassified into earnings over the next twelve months	$ 3	$(1)	$ 2

Hedges of Net Investment in a Foreign Operation

During the year ended December 31, 2005, the company has not maintained any hedges of net investment in a foreign operation.

Derivatives not Designated in Hedging Relationships

The company uses forward exchange contracts to reduce its net exposure, by currency, related to foreign currency-denominated monetary assets and liabilities. The netting of such exposures precludes the use of hedge accounting. However, the required revaluation of the forward contracts and the associated foreign currency-denominated monetary assets and liabilities results in a minimal earnings impact, after taxes. Several small equity affiliates have risk management programs, mainly in the area of foreign currency exposure, for which they have elected not to pursue hedge accounting. In addition, the company maintains a few small risk management programs for agricultural commodities that do not qualify for hedge accounting treatment.

In 2003, in conjunction with the acquisition of the 23.88 percent minority interest in DuPont Canada (see Note 27), the company entered into option contracts to purchase 1.0 billion Canadian dollars for about $700, in order to protect against adverse movements in the USD/Canadian dollar exchange rate. The changes in fair values of these contracts were included in income in the period the change occurred. The contracts expired during the second quarter 2003 resulting in a pretax exchange gain of $30.

Currency Risk

The company routinely uses forward exchange contracts to offset its net exposures, by currency, related to monetary assets and liabilities of its operations that are denominated in currencies other than the designated functional currency. The primary business objective of this hedging program is to maintain an approximately balanced position in foreign currencies so that exchange gains and losses resulting from exchange rate changes, net of related tax effects, are minimized.

From time to time, the company will enter into forward exchange contracts to establish with certainty the functional currency amount of future firm commitments denominated in another currency. Decisions regarding whether or not to hedge a given commitment are made on a case-by-case basis, taking into consideration the amount and duration of the exposure, market volatility, and economic trends. Forward exchange contracts are also used from time to time to manage near-term foreign currency cash requirements and to place foreign currency deposits and marketable securities investments.

Interest Rate Risk

The company primarily uses interest rate swaps to manage the interest rate mix of the total debt portfolio and related overall cost of borrowing.

Interest rate swaps involve the exchange of fixed for floating rate interest payments that are fully integrated with underlying fixed-rate bonds or notes to effectively convert fixed rate debt into floating rate debt based on three- or six-month USD LIBOR.

At December 31, 2005, the company had entered into interest rate swap agreements with total notional amounts of approximately $2,900, whereby the company, over the remaining terms of the underlying notes, will receive a fixed rate payment equivalent to the fixed interest rate of the underlying note and pay a floating rate of interest that is based on three- or six-month USD LIBOR.

Interest rate swaps did not have a material effect on the company's overall cost of borrowing at December 31, 2005 and 2004. See Note 21 for additional descriptions of interest rate swaps.

Commodity Price Risk

The company enters into over-the-counter and exchange-traded derivative commodity instruments to hedge the commodity price risk associated with energy feedstock and agricultural commodity exposures.

30. Geographic Information

	2005		2004		2003	
	Net Sales [1]	Net Property [2]	Net Sales [1]	Net Property [2]	Net Sales [1]	Net Property [2,3]
United States	$11,129	$ 7,131	$11,591	$ 7,161	$12,117	$ 7,452
Europe						
Belgium	$ 200	$ 144	$ 231	$ 133	$ 242	$ 115
Germany	2,040	359	2,047	390	1,946	528
France	986	124	996	130	982	133
Italy	799	26	876	28	959	29
Luxembourg	53	186	39	188	27	181
Netherlands	192	228	175	215	187	375
Spain	457	248	504	208	484	347
United Kingdom	657	124	697	68	710	714
Other	2,312	251	2,428	248	1,885	227
Total	$ 7,696	$ 1,690	$ 7,993	$ 1,608	$ 7,422	$ 2,649
Asia Pacific						
China/Hong Kong	$ 1,198	$ 175	$ 1,197	$ 138	$ 1,232	$ 232
India	287	18	287	15	198	16
Japan	1,107	98	1,183	88	899	81
Taiwan	391	112	564	107	792	547
Korea	563	63	526	54	509	51
Singapore	147	46	168	53	128	343
Other	822	45	800	51	784	53
Total	$ 4,515	$ 557	$ 4,725	$ 506	$ 4,542	$ 1,323
Canada & Latin America						
Brazil	$ 1,055	$ 270	$ 920	$ 251	$ 860	$ 481
Canada	897	171	875	243	894	676
Mexico	698	198	581	169	568	169
Argentina	241	29	232	29	221	85
Other	408	263	423	257	372	185
Total	$ 3,299	$ 931	$ 3,031	$ 949	$ 2,915	$ 1,586
Total	$26,639	$10,309	$27,340	$10,224	$26,996	$13,020

1 Net sales are attributed to countries based on location of customer.

2 Includes property, plant and equipment less accumulated depreciation.

3 Includes INVISTA assets held for sale.