Early Termination and Liquidation Provisions in Energy Trading and Marketing Agreements

August 22, 2003

DALLAS BAR ASSOCIATION
OIL, GAS & ENERGY LAW SECTION
ANNUAL REVIEW OF OIL, GAS & ENERGY LAW XVIII

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Table of Contents

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I. Master Agreements in General

The term "master agreement" generally means an agreement, often standardized for a commodity, with terms and conditions that will apply to multiple transactions, each evidenced by a transaction confirmation. Master agreements can be used for physically-delivered commodities or over-the-counter derivative transactions.[1] Standardized master agreements are commonly used to manage the risks associated with energy trading and marketing transactions. Recent history demonstrates that such risks are numerous and substantial and can be costly if left unmitigated. Several events, including Enron's bankruptcy,[2] the recent and ongoing credit rating downgrades of some of the industry's largest energy trading companies, and the subsequent exit from the industry of some of those companies,[3] have dramatically changed the way many energy trading and marketing companies view, measure and mitigate credit risk. This change in perspective is causing companies to re-examine master agreements to take advantage of some of the hard lessons learned in the months following Enron's bankruptcy filing. In addition, non-traditional participants are entering the market and bringing with them new ideas concerning credit and risk management. One type of contractual provision used to manage credit risk in master agreements is the early termination and liquidation provision. This paper analyzes the contents, mechanics and implications of early termination and liquidation provisions commonly used in master agreements.

A. Remedies found in master agreements

Master agreements typically contain two types of remedies for the breaching party's nonperformance: liquidated damages and early termination and liquidation. Upon a party's breach of its obligation to deliver or receive a commodity under a master agreement, the non-breaching party is usually entitled to recover liquidated damages.[4] Liquidated damages can be calculated using the cover standard, which provides for the recovery of the difference between the contract price and the market price to purchase substitute quantities of the commodity,[5] or the spot standard, which is calculated by subtracting the contract price from either the market price quoted by independent market participants or a published, index price.[6] While these liquidated damages typically include incremental costs incurred as a result of the breach and the subsequent covering process, such as imbalance penalties or additional transmission costs,[7] they exclude other costs, such as administrative costs incurred in replacing the transaction.[8] Upon an event of default, termination and liquidation provisions define the non-defaulting party's rights under the master agreement. Events of default are carefully defined in master agreements but usually include any significant breach other than those related to the failure to deliver or receive a physical commodity for which liquidated damages apply.

B. Liquidated damages compared to early termination and liquidation rights

Liquidated damages and early termination and liquidation differ in several material respects. Liquidated damages are usually the non-defaulting party's sole and exclusive remedy for the other party's failure to perform its obligations to deliver or receive the energy commodity under a master agreement between the parties. As a result, the payment by the defaulting party of the liquidated damages prevents an event of default under the agreement and the affected transactions and the master agreement continues in full force and effect. Industry participants typically treat liquidated damages as a routine occurrence and envision the continuation of the master agreement and the transaction despite the failure that caused the liquidated damages. However, in some cases, the parties have added provisions whereby repeated or continuing failures to deliver or receive the energy commodity may give rise to an event of default.

In contrast, early termination and liquidation rights arise when there has been an occurrence, other than a failure to deliver or receive a commodity for which liquidated damages apply, that has global implications upon performance under the master agreement and/or the financial obligations of the parties. These occurrences typically relate to the credit, payment history, ability to perform, and/or solvency of the defaulting party. The broad scope of events of default can cause their occurrence under one agreement to create early termination and liquidation rights under another agreement. Likewise, a failure on the part of or action of a guarantor or affiliate of a party to a master agreement can also constitute an event of default. Upon an event of default, early termination and liquidation provisions usually provide a number of rights to the non-defaulting party, including: (i) the right to terminate all outstanding transactions under a master agreement; (ii) the right to liquidate the terminated transactions; (iii) the right to setoff amounts due under such transactions and, in some cases, across master agreements and across affiliates; and (iv) the right to suspend payment and/or performance obligations under the master agreement. [9] The exercise of a party's rights under termination and liquidation provisions causes the cessation of, at a minimum, the terminated and liquidated transaction(s), and usually the entire master agreement and all transactions thereunder.

II. Summary of Early Termination and Liquidation Clauses

A. History of clauses in relation to master agreements

Early master agreements for physical energy transactions did not contain early termination and liquidation provisions. These provisions were originally only found in the ISDA master agreement,[10] which the energy markets began to use in the late 1980's to document interest rate and currency swap transactions.[11] During the 1990's, as physical energy market participants became more sophisticated in the manner in which risk was measured and controlled, existing master agreements were amended and new master agreements were drafted to include termination and liquidation provisions.[12] Today, early termination and liquidation provisions are nearly ubiquitous and may be found in a master agreement, in an overlying agreement, such as a master netting agreement, or an underlying agreement, such as a transaction confirmation.

B. Events of default

Early termination and liquidation rights are triggered by the occurrence of events of default. Because termination and liquidation is a severe remedy, parties should use great care to select and define the circumstances that constitute events of default. An event of default is usually an objective occurrence such as a bankruptcy filing or the failure to provide collateral when requested, and as a result, there is typically little right to dispute the existence of an event of default. Once an event of default occurs, master agreements typically do not provide cure periods which must expire prior to termination and liquidation because the event of default generally does not materialize until some notice and cure period has already elapsed.[13]

C. Termination events

Some master agreements, such as the ISDA, contain termination events in addition to events of default.[14] Termination events include occurrences such as a tax event, a tax event upon merger and the occurrence of an illegality.[15] While it is possible that termination events can give rise to the right to terminate and liquidate all transactions under an agreement, termination events are usually intended to provide remedies when the complete liquidation of an agreement is not warranted. To achieve this result, termination events provide remedies relating to specific transactions while not disturbing the master agreement or the non-affected transactions.[16] Termination events may even offer the defaulting party the right to transfer the master agreement to an affiliate to avoid the termination event.[17] As a result, when drafting master agreements, care should be exercised to ensure that events of default include only events that will affect all transactions (*e.g.*, bankruptcy) while termination events are used for those events that affect only a limited number of transactions (*e.g.*, a new tax on certain transactions).[18]

D. Summary of the early termination and liquidation remedy

The most fundamental remedy available upon the occurrence of an event of default is the right to terminate the master agreement and liquidate all transactions and, similarly, upon the occurrence of a termination event, the right to terminate and liquidate the affected transactions. Most master agreements are drafted so this is a right and not an obligation, permitting the non-defaulting party to wait before terminating and liquidating transactions or to decide not to terminate and liquidate at all. Some agreements limit the time during which the non-defaulting party may delay an early termination and liquidation, in which case, the non-defaulting party must terminate and liquidate the agreement before the right to do so expires or lose the right to do so. Also, many master agreements are drafted so that liquidation must take place within a predetermined period following termination of the transactions.[19]

It may seem counterintuitive that a party, upon the conference of a right to take action in light of the other party's breach, would prefer to delay or not to exercise that right. However, the early termination and liquidation remedy is one of great finality and significance, and a party may wish to delay its exercise if: (i) it did not wish to end the trading relationship with the defaulting party; (ii) it believed the defaulting party was going to cure the event of default with no lasting harm to either party; (iii) the non-defaulting party would owe the defaulting party the settlement payment; (iv) the non-defaulting party desired to use the threat of terminating and liquidating the master agreement as leverage to negotiate an agreement of some sort with the defaulting party while continuing the trading relationship.[20] Likewise, it is sometimes necessary to liquidate after the early termination date to account for market volatility, the availability of trading counterparties, the liquidity of the transaction, credit or contractual arrangements that must be made with counterparties, or administrative issues the non-defaulting party faces.

E. Summary of liquidation

Once a contract is terminated following an event of default or affected transactions are terminated following a termination event, the non-defaulting party must liquidate the transactions. When transactions are liquidated, the non-defaulting party ascertains the value of the terminated transactions taking into account market price, replacement cost, forward commodity price curves or other method specified by the parties and the present value of money. The gains and losses the non-defaulting party realizes for each liquidated transaction are then netted against each other, resulting in a single liquidation amount for all terminated transactions under the master agreement.

F. Summary of setoff

Most master agreements specifically permit the non-defaulting party to setoff obligations between the parties, and this right may be available at common law even if it is not conferred by the contract. Contractually-provided setoff can be cross-product, cross-affiliate, cross-collateral, one-way (excluding amounts owed to the defaulting party other than the termination amount) or two-way (including all amounts owed between the parties).

III. Mechanics of Procedure

A. Events of default

The early termination and liquidation of transactions under a master agreement must begin with the occurrence of an event of default or termination event. The most common events of default include: (i) the failure to make payment under the master agreement; (ii) the failure to deliver collateral when required; (iii) the failure of credit support previously transferred, such as the repudiation of a guaranty or letter of credit; (iv) the breach of a representation or warranty in the master agreement; (v) the failure to comply with or timely perform any covenant or obligation under the master agreement other than the failure to deliver or receive the commodity for which liquidated damages apply; (vi) bankruptcy; (vii) a merger that detrimentally affects the creditworthiness of the surviving entity; (viii) the failure by a surviving entity or credit support provider to assume the obligations of a party upon a consolidation or merger; (ix) the failure of a guaranty to continue in effect after a consolidation or merger; (x) the occurrence of an event of default under or the early termination and liquidation of another agreement between the parties; and (xi) the failure to provide adequate assurances of performance upon demand.[21] Termination events are commonly events such as the illegality of certain transactions, a new tax affecting certain transactions, or a tax that would be owed due to the merger of a party with a third party.[22] Appendix A lists common events of default and termination events and identifies a sampling of the standard form master agreements in which they are found.

1. New events of default

Following the Enron bankruptcy, some industry participants are adding additional events of default to their master agreements. One new event of default is the occurrence of a payment default under any other agreement with any other party. Like other cross-default provisions, the payment default is typically tied to a dollar value threshold to eliminate normal business disputes and inconsequential defaults. While cross-default provisions typically contemplate cross-default upon a failure to make a payment under another agreement between the parties, this new cross-default provision addresses the failure to make payment to a third party under any agreement.[23] The enables a party to terminate the contractual relationship when its counterparty begins to default on its payment obligations to others without being forced to wait for the counterparty to default on a payment obligation to the party. However, due to difficulties in discovering and determining whether a default has occurred and whether the applicable threshold has been exceeded, enforcement of this event of default is often very difficult.[24] If a party invokes this event of default such party risks being liable for wrongful breach of the master agreement. Further, confidentiality obligations may be breached in obtaining the information necessary to make such determinations, which could have adverse consequences for both the party breaching the obligation and the party receiving the information.

A similar event of default arising in the wake of Enron's bankruptcy occurs when an event of default or other default occurs under any agreement that a party has with any third party. This is tremendously broad, extending beyond payment defaults or defaults under enumerated events of default, and has the inherent advantage of ensuring that a counterparty will never be forced to wait on the sideline, unable to act when a counterparty begins sliding toward the default of all of its obligations. However, in addition to raising information discovery and evaluation difficulties, this event of default also creates the risk that a *de minimis* default under a wholly unrelated agreement will result in the termination and liquidation of all agreements between the parties. Although a threshold solves this issue with respect to monetary defaults, no similar mechanism exists to discriminate between significant and insignificant performance defaults to which a monetary value is not easily ascribed.

A variation of the two foregoing events of defaults occurs when there is a default under any agreement between either of the parties and an affiliate of the other party or a default under any agreement between affiliates of the parties. The advantage of this event of default is it looks to the systemic health of the counterparty's entire organization. The disadvantage, however, is the risk of entangling the obligations of unrelated and separately managed affiliates, possibly in violation of corporate governance, regulatory and/or organizational rules, such as holding a regulated affiliate responsible for an unregulated affiliate's obligations, which could result in regulatory sanctions. In addition, this greatly increases the complexity of the obligations of the parties, particularly when the affiliates have different guarantors or if foreign affiliates are involved. In fact, in a time when it is not uncommon for large energy companies to have hundreds of affiliates worldwide engaging in a wide variety of regulated and unregulated activities, it may be a practical impossibility for a party to keep track of all of its and its affiliates' relationships with all of its counterparties and their affiliates. Further, regulated and unregulated affiliates are often prohibited from sharing information and may therefore be prohibited from tracking whether one could be liable for the other's obligations.

Another possible event of default relates to a change in the ownership structure of the party resulting in its guarantor's ownership interest falling below a certain percentage. The premise behind this event of default is the fear that the guaranty would cease to be enforceable if the guarantor ceased to own a significant percentage of the party. A variant of this type of event of default provides that an event of default would occur only if the affected party failed to give notice of such ownership change within a certain period of time thereof. One drawback to this event of default is the possibility that the guarantor could remain extremely creditworthy and obligated under the applicable guaranty regardless of the guarantor's ownership share. If this occurred, the non-defaulting party would have the right to terminate the master agreement and all transactions even though a guaranty from a creditworthy entity remained in place and enforceable. In addition, a guarantor may not have any direct ownership interest in the party on whose behalf it provides credit support, in which case the ownership share it holds of the underlying company may not relate in any meaningful way to its enforceability.

2. <u>Notice and cure period</u>

The Enron bankruptcy has heightened awareness of the constraints to the non-defaulting party's rights in the event of a bankruptcy of the other party. Many events of defaults require notice from the non-defaulting and provide for a period of time during which the party in default may cure the default. In such cases, the cure period commences when the notice is received by the defaulting party and must elapse without the default being cured before an event of default arises. However, a party may be prohibited from providing such notice if the defaulting party is under the protection of the automatic stay provisions of the Bankruptcy Code. Accordingly, some parties are adding provisions to their master agreements that eliminate the requirement to provide a notice of default by the non-defaulting party if such notice is prohibited by law or any court order. In such case, the cure period would automatically commence upon the occurrence of the default rather than the receipt of notice of such default from the non-defaulting party.

B. <u>Notice of an event of default and early termination date</u>

Most master agreements are drafted to permit a non-defaulting party to declare an early termination date by giving the defaulting party notice of the existence of the event of default and the date upon which early termination and liquidation will occur.[25] While the notice must typically be in writing, master agreements generally do not provide for any cure period following notice.[26] Notice is not required when the parties elect automatic early termination upon the occurrence of certain events of default. This automatic early termination option is found in the ISDA[27] and is sometimes added to other master agreements by agreement of the parties. Automatic early termination usually applies to events of default related to bankruptcy and is intended to help ensure that a party will not have its rights prejudiced by a counterparty's bankruptcy. "The primary advantage of automatic early termination [is] that . . . it may be more likely in some jurisdictions that a non-defaulting party may exercise its termination rights outside of an insolvency proceeding."[28] Most parties choose not to elect this option in order to preserve control over when and whether their transactions will be terminated and liquidated and because most parties believe the termination and liquidation rights are enforceable following an insolvency proceeding. The risk that transactions may be automatically terminated without a non-defaulting party's knowledge could be dangerous for a non-defaulting party because the non-defaulting party could be left with unhedged positions. Further, it may be disadvantageous to the non-defaulting party for automatic early termination to occur if, based on the market prices at the time of the automatic early termination, the non-defaulting party would owe an immediate settlement payment to the defaulting party upon termination.

C. Election of remedy

Once an event of default has occurred, the non-defaulting party must elect a remedy. The most common remedies available in addition to the right to terminate and liquidate the agreement are the rights to suspend performance, withhold payment, demand the return of collateral from the defaulting party, and suspend the return of collateral to the defaulting party.[29] If the non-defaulting party elects a remedy other than termination and liquidation, its right to exercise this remedy may be limited if the event of default is the bankruptcy of the defaulting party, as these remedies may constitute impermissible ipso facto provisions unless their exercise can be based on an event of default other than the bankruptcy of the defaulting party.[30]

If the non-defaulting party elects to terminate the agreement, it must: (i) provide the defaulting party notice of the termination, including the date on which termination will be effective; and (ii) determine whether all transactions can be liquidated as of the early termination date or whether some transactions must be liquidated after the early termination date because it is impractical or impossible to terminate such transactions on the early termination date.[31]

1. Cherry-picking transactions to terminate

One aspect of termination that may vary across master agreements is the issue of whether all transactions must be terminated or whether the non-defaulting party may "cherry-pick" the transactions it wishes to terminate while preserving the continuation of the other transactions. Some parties advocate the practice of cherry-picking transactions to terminate because they believe it will act as a deterrent to the other party's breach of the agreement. Critics of this technique question its enforceability and raise the concern that it may incentivize parties to declare events of default on a pretextual basis in order to liquidate transactions after advantageous market movements. This technique is also contrary to the practice of terminating the future trading relationship of the parties when an early termination date occurs. Energy trading and marketing master agreements have moved against the practice of cherry-picking, and it is now most common for contracts to specify that all transactions must be terminated when an early termination date is declared.[32]

2. Power Marketing and Asset Management Agreements

In circumstances where the parties have entered into a master agreement in connection with an exclusive power marketing or asset management arrangement, additional consideration should be given to the effect of a termination and liquidation of all transactions and it may be appropriate for the parties to agree that certain transactions or functions of the parties would continue after a termination for default. For example, in an asset management agreement where a party serves as the exclusive power marketer and gas supplier of a power generator, a sudden termination of the relationship and liquidation of all transactions would severely impair the power generator's ability to generate and sell power and could result in an inability for the other party to realize any settlement amount due to it. Accordingly, the parties may agree that upon an event of default of the power generator, under certain circumstances (*e.g.*, an event of default that does not render the power generator incapable of performing, the power generator continues to perform its delivery obligations, and the required collateral is maintained), the other party would be prohibited from terminating and liquidating the transactions. The rationale for this provision is that so long as the power generator is performing, after giving effect to typical netting and/or offset provisions, the power generator would, under normal circumstances, be owed money from the other party under the transactions. The suspension of the other party's rights to terminate and liquidate would give the parties an opportunity to fully perform the transactions, provide for assignment of the transactions in lieu of termination, or provide for an orderly liquidation of the transactions.

3. Non-exclusive nature

In contrast to the liquidated damages remedy for a failure to deliver or receive a commodity, one characteristic of the early termination and liquidation provision is that it is typically one of several remedies for the triggering event of default. Exclusive remedies are usually used in commodity contracts to avoid any risk of the imposition of damages other than actual direct damages and to avoid any extraordinary equitable relief in recognition that the harm resulting from a failure to deliver or receive a commodity can be usually wholly remedied by liquidated damages. The non-exclusive nature of early termination and liquidation is based upon the premise that the occurrence of an event of default is such an extreme event that the non-defaulting party should be given the greatest possible degree of latitude in mitigating and recovering its damages.

D. Liquidation

After an early termination date has been designated, all terminated transactions must be liquidated. Liquidation is the process by which the value of the terminated transactions is ascertained by the calculating party. Although liquidation usually occurs as of the termination date, some master agreements provide that if it is commercially impractical to liquidate the transactions on such date, the liquidation must occur as soon as reasonably practicable thereafter.[33] Although the non-defaulting party is generally the calculating party,[34] third parties can be used to ensure the objectivity of the valuation. The parties usually designate in the master agreement one of two methods used to calculate the liquidation value of the terminated transactions.

1. Market quotation versus loss

The market quotation method calculates the non-defaulting party's damages by comparing the difference between the contract price for each transaction and the market price for an equivalent transaction.[35] Market prices can be determined by reference to a published index[36] or on the basis of quotations from leading market participants in the relevant market.[37] Although a reference to a published index is the most objective and verifiable method of determining the market price, not all transactions are fairly represented by a standardized published index. Therefore, in some cases, it is better to rely on third-party quotations. To help ensure the quality and reliability of the third-party quotations, parties may designate the number and qualifications of the market participants from whom the quotations will be obtained. Common criteria used to select the quotation sources are creditworthiness, experience in the market and location. If more than one market quotation is required, the methodology for determining the final market price based on such quotations must be set forth in the agreement. If a party wishes to have the flexibility to obtain separate quotations for each terminated transaction or an aggregate quotation for the entire portfolio of terminated transactions, the master agreement must be carefully drafted to provide this option.

Market quotation is generally considered the more objective method in that there is a lower risk of gaming by the non-defaulting party in order to increase the payments owed to it for the terminated transactions. The primary disadvantage of market quotation is that the non-defaulting party may be unable to obtain the required number of market quotations from leading dealers, a risk that is particularly acute in light of the dramatic reduction in liquidity in the energy markets following Enron's bankruptcy. In addition, market conditions, including the timing of the liquidation, may prevent the non-defaulting party from actually entering into a replacement transaction at a price which is equal to the average of the market quotations, particularly if the transaction is for an illiquid product or delivery occurs at an illiquid delivery point.[38] These problems can cause the non-defaulting party to be over- or under-compensated. Finally, the market quotation method does not specifically provide for the recovery of any related costs incurred in replacing the transactions, including the costs of unwinding hedges and broker fees. As a result, the non-defaulting party may not be fully compensated for its damages when the market quotation method is used.

Some parties include provisions in master agreements which allow the non-defaulting party to derive the market price from any source used in its regular course of business for valuing similar transactions, including such party's internal price curves, rather than relying solely on a third-party source. While this method provides the non-defaulting party with flexibility in calculating the settlement amounts, it is less transparent and objective than other methods.

The loss method measures the damages incurred by the non-defaulting party by calculating the non-defaulting party's total losses or gains and costs resulting from the early termination and liquidation, including any loss of bargain, cost of funding, and costs of terminating or reestablishing any hedge.[39] In theory, the advantage of the loss method is that it is a more precise measure of damages, as it captures all losses incurred by the non-defaulting party while avoiding under-compensating the non-defaulting party. However, as a practical matter, the inherent subjectivity of this method raises concerns that calculations will be difficult to verify. This subjectivity also increases the likelihood of disputes arising out of the damages calculations and the initiation of lawsuits to resolve these disputes. This is undesirable for the non-defaulting party, as a protracted legal proceeding to resolve the calculation of damages will negate much of the time advantage typically gained by terminating and liquidating the outstanding transactions, particularly when the defaulting party is bankrupt, as this litigation will inevitably involve the supervision of the bankruptcy court as well.

In circumstances where the parties are intending to enter into short-term, as well as long-term, complex transactions, it is not uncommon for the parties to agree to the market quotation method for determining the measure of damages for the short-term transactions and the loss method for determining the measure of damages for the long-term, complex transactions.

2. Net present value

Once the value of the liquidated transactions has been determined using either the market quotation or loss method, such values are then discounted to their present value using a reasonable interest rate to account for the time value of money. The interest rate may be negotiated ahead of time and included in the master agreement. In most cases, the parties elect to have the interest rate determined by reference to a published rate such as the prime rate or the London Interbank Overnight Rate. This methods used to ensure that the agreed upon interest rate will reflect the market rate at the time of the calculation. After the present values for all liquidated transactions are calculated, these values are netted against each other to determine a single liquidated transaction amount.[40]

3. Disputed valuations

Parties should consider adding provisions to their master agreements that govern the resolution of disputes concerning the valuation of liquidated transactions. It is helpful to establish a dispute resolution system in advance as: (i) goodwill between the parties typically evaporates upon the occurrence of an event of default; (ii) the discretion the non-defaulting party enjoys in calculating termination values places the defaulting party at an inherent disadvantage and leads to a natural suspicion of the non-defaulting party's fairness and accuracy in calculating the Settlement Amount; (iii) the end of the parties' relationship removes any incentive to cooperate with each other; and (iv) when the defaulting party is in bankruptcy, the defaulting party has every incentive to challenge the non-defaulting party's calculations. These types of disputes are sometimes required to be resolved by arbitration. In other cases this is addressed by requiring the defaulting party to post collateral to the non-defaulting party in an amount equal to the disputed portion of the Settlement Amount, thereby incentivizing the defaulting party to raise only bona fide disputes and providing the defaulting party a mechanism to verify the values used to calculate the Settlement Amount.

4. One-way versus two-way payment

After the transactions under a master agreement are liquidated into a single amount owed by one party to the other, the payment of this amount is governed by whether payments are "one-way" or "two-way."[41] In a one-way payment situation, only the non-defaulting party may receive a Settlement Amount and any obligation to pay a Settlement Amount owed to the defaulting party is cancelled, whereas in a two-way payment situation either party may receive a Settlement Amount.

Proponents of one-way payment argue that a party should not be rewarded for its breach, the one-way payment incentivizes the potentially defaulting party to avoid the occurrence of an event of default, and the agreement of the parties should be respected even if the result seems to be unfair. However, some parties feel that one-way payment is a punishment for the defaulting party's non-performance rather than compensation for the non-defaulting party's losses and that this could cause one-way payment to be unenforceable because it would be punitive rather than compensatory in nature. Further, the possibility of a windfall under one-way payment could create an incentive for a party to declare an event of default on pretext in order to avoid paying amounts owed to the other party for a transaction.

Proponents of two-way payment assert that: (i) a party's breach pursuant to an event of default should not result in that party's loss of the benefit of the bargain so long as the non-defaulting party is kept whole; (ii) two-way payment is more equitable; (iii) a party cannot manage the risk that it might lose the value of its in-the-money forward positions upon the occurrence of an event of default; and (iv) two-way damages are more likely to be enforced with less delay, expense and inconvenience than are one-way damages. Although at least one court has found that one-way payments are enforceable under certain circumstances,[42] this approach is generally not recognized and most energy trading and marketing master agreements utilize two-way payment. Reasons for this preference include the general legal principle that liquidated damages should not result in a windfall for the non-breaching party,[43] the fact that a non-defaulting party is kept whole by two-way payment, the concern that one-way payment is unenforceable due to its punitive rather than compensatory nature, and the desire to avoid litigation that may arise if one-way payment is effected.

E. Setoff

1. In general

Setoff originated as a common law remedy "grounded on the absurdity of making A pay B when B owes A."[44] Setoff is important "because, without an effective set-off clause, the Non-defaulting Party might be required to make payment to the Defaulting Party . . . upon termination while, at the same time, the Non-defaulting Party may not have any realistic expectation of receiving payments owed to it by the Defaulting Party (and its Affiliates) under other agreements."[45] The most common form of setoff is the setoff of obligations owed between parties under a single agreement.

Setoff can be a common law right, procedural right or contractual right.[46] Contractual setoff is usually preferred because it eliminates the uncertainty of whether the necessary elements to use common law setoff or procedural setoff have been met. In general, contractual setoff provisions are enforceable even if the requirements for common law setoff have not been met.[47]

Setoff is of great importance to the non-defaulting party because, as to the obligations that are setoff: (i) it extinguishes the obligations without any further action of any type, including any action in any court or other judicial setting; (ii) it removes the non-defaulting party's credit risk for other amounts it is owed by the defaulting party; (iii) it removes the market risk of positions moving in directions adverse to the non-defaulting party before the non-defaulting party receives payment; (iv) it removes the non-defaulting party's cash flow risk while waiting for payments; (v) it allows the non-defaulting party to avoid entanglement in bankruptcy proceedings; and (vi) when the defaulting party is bankrupt, it minimizes any payment the non-defaulting party must make to the insolvent counterparty who is unlikely to make any payment it owes to the non-defaulting party.

2. Cross-product setoff

It is usually beneficial to the non-defaulting party to setoff as many of its obligations to the defaulting party as possible. Cross-product setoff allows the non-defaulting party to setoff obligations arising under different types of energy agreements and to minimize its payment obligations on a portfolio-wide, rather than agreement-by-agreement, basis.[48]

In some cases cross-product setoff involves setting off forward contracts against swap agreements, which minimizes a final settlement payment following a termination and liquidation. Further, this process serves as a tool to aggregate exposure across all trading products with a counterparty to permit the flexible use of credit lines across products and more efficiently utilize posted collateral. Although energy trading and marketing companies tend to treat forward contracts and swap contracts as opposite sides of the same coin, the Bankruptcy Code discusses them in separate sections and does not discuss whether swaps and forward contracts may be setoff against each other during the existence of the automatic stay.[49] Likewise, no cases have expressly ruled that this type of setoff is permissible. While a leading bankruptcy authority has expressed approval of this type of cross-product setoff,[50] and a bankruptcy reform bill pending in Congress would expressly authorize it,[51] it is currently unclear whether this type of setoff may be effectuated during an automatic stay. If it is found that cross-product setoff is not specifically provided for under the exemptions to the automatic stay for forward contracts and swap agreements, a party will be required to obtain relief from the automatic stay before effecting this cross-product setoff, in which case the right to such setoff is not lost but merely delayed.[52] Energy trading and marketing agreements often address this issue by characterizing all amounts owed under each forward or swap agreement as collateral for every other agreement between the parties.[53] While this strategy is judicially and regulatorily untested, it is widespread in the industry and seems to be consistent with the intent of the Bankruptcy Code.[54]

3. Cross-party setoff

Cross-party setoff involves the setoff of amounts owed between the parties to the contract and their affiliates. The affiliates involved in this type of setoff usually include any guarantors of the parties but may include other affiliates as well. The setoff of amounts owed between counterparties and their affiliates is called triangular setoff and is generally not enforceable under common law or procedural setoff rights.[55]

An exception to the rule that triangular setoff is not enforceable may exist when the setoff right is contractual and specifically provided for in a pre-petition contract.[56] A leading bankruptcy commentator has also recognized this right:

> "Triangular setoffs are not generally allowed under applicable nonbankruptcy law, and it is generally recognized that bankruptcy does not expand the rights of creditors beyond their non-bankruptcy entitlements. . . . A narrow exception [to the prohibition against triangular setoffs] exists with respect to certain setoffs that are contractually based. If the parties all agree in a prepetition contract that a setoff may be taken between A, B, and C, then the agreement may be enforced in bankruptcy to the extent that it is enforceable under applicable non-bankruptcy law. However, a formal, prepetition contract is required, and industry practice is not a sufficient substitute for a binding contractual arrangement."[57]

As energy trading and marketing companies increasingly diversify their corporate structure to fragment the roles of affiliated entities, triangular setoff becomes increasingly important to manage risk among multiple affiliates trading under the same ultimate parent.[58] Triangular setoff is a much more efficient means to manage credit exposure and maximize the efficiency of collateral than limiting setoff to the obligations of the parties under each contract, and the need for the broader rights of triangular setoff are even more acute when affiliates share the same guarantor of their obligations.[59]

4. Setoff of collateral

It is clearly advantageous for a creditor to be able to setoff obligations owed by a debtor against collateral posted by the debtor and held by the creditor. The Bankruptcy Code is supportive of this objective, exempting from the automatic stay the right to setoff settlement payments arising out of forward contracts and owed to a creditor against cash, securities or other property held by or due from the creditor to margin, guarantee, secure or settle forward contracts.[60] Likewise, the Bankruptcy Code exempts from the automatic stay the right to setoff mutual debts under or in connection with any swap agreement or against cash securities or other property of the debtor held by or due from the creditor to guarantee, secure or settle any swap agreement.[61] In order to setoff collateral posted by the defaulting party against a Settlement Amount, the collateral must be posted by the defaulting party to the non-defaulting party and the non-defaulting party must have a perfected security interest therein.

5. Priority of setoff right

Where one party to a master agreement has assigned or granted a security interest in its accounts receivable to a secured party as security for such party's obligation to repay money lent by the secured party, a dispute may arise between the secured party and the other party to the master agreement desiring to exercise its offset rights. The following is a brief discussion of the relevant issues for consideration relating to such a dispute and focuses primarily on the New York and Texas law.

a. <u>What law applies</u>

New York courts have consistently applied Article 9 of the Uniform Commercial Code ("Article 9") to govern the priority between a party holding a perfected security interest in an account and an account debtor under such account possessing offset rights.[62] Likewise, applying Texas law, the Eighth Circuit Court of Appeals held in *In re Apex Oil Co.*, 975 F.2d 1365, 168-169 (8th Cir. 1992) that Article 9 governs the priority between a right of setoff and a perfected security interest in an account. In such a priority dispute, the general "first to file or perfect" rule is inapplicable and §9-404(a) prevails.[63] §9-404(a) states:

> (a) . . . Unless an account debtor has made an enforceable agreement not to assert defenses or claims, and subject to subsections (b) through (e), the rights of an assignee are subject to:
>
> (1) all terms of the agreement between the account debtor and assignor and any defense or claim in recoupment arising from the transaction that gave rise to the contract; and
>
> (2) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives a notification of the assignment authenticated by the assignor or the assignee.

Although such section uses the term "assignee" rather than "secured party," the *Apex* court and New York courts have found that §9-404 nonetheless is applicable to a priority dispute between the account debtor and the secured party.[64] The *Apex* court reasoned that an assignment for purposes of Article 9 may or may not be an assignment under general property law that effects an absolute and irrevocable transfer of ownership.[65] The court stated that "Article 9's primary purpose is to regulate security agreements, not transfers or sales, which are governed primarily by Article 2. When an assignment is intended for purposes of security, . . . it is subject to Article 9."[66]

It should be noted, however, that a subsequent Texas court addressing the priority of a setoff right in an account versus a security interest in the account held that §9-318(1) (the predecessor to §9-404(a)) was inapplicable.[67] Based on §9-318(1)'s use of the term "assignee", the court reasoned that §9-318(1) required the outright assignment of the account before that section could be applied.[68] Without citing any authority for its interpretation, the court held that the grant of a security interest in an account did not amount to an assignment of an account.[69] Because the court found no evidence of an assignment of the account, the court held that §9-318(1) did not apply.[70] However, this finding is inconsistent with the findings of other Texas courts that, while not directly addressing a dispute between an account debtor and a secured party, have found that an assignee of an account and a party with a security interest in such account are the same thing for purposes of Article 9.[71]

b. <u>Application of §9-404(a)</u>

Under §9-404, the relevant issues are how and when the setoff claim arose in relation to the security interest. §9-404(a) distinguishes between (1) claims and defenses (such as offsets) arising from the assigned contract and (2) other unrelated claims and defenses not arising from the contract. Under §9-404(a)(1), if the account debtor's offset rights and the assigned account arise from the same contract, the account debtor's offset rights will have priority over a prior perfected security interest in such account regardless of the existence (known or otherwise) of the security interest.[72] However, §9-404(a)(2) limits the assertion by the account debtor of unrelated claims and defenses to those which accrue before the account debtor receives notification of the assignment. For purposes of §9-404(a)(2), the account debtor must have actual notice of the assignment; constructive notice by the filing of a financing statement is not sufficient.[73]

Since notice of an assignment of accounts is irrelevant in determining the priority of a setoff claim by the account debtor that arises out of the same contract, the parties should carefully draft the master agreement to provide that the master agreement and all transactions thereunder constitute a single contract for purposes of §9-404. In determining whether there is a single contract or whether there are severable contracts for purposes of §9-404, the intent of the parties at the time of the agreement is to be considered.[74] This intent must be clearly stated. In finding that a distribution agreement and the purchase orders arising thereunder were not the same contract for purposes of Article 2 of the Uniform Commercial Code, the Seventh Circuit Court of Appeals was not persuaded by a clause in the distributorship agreement providing as follows:

> *Entire Agreement.* This Agreement, together with all attachments hereto and all purchase orders issued hereunder constitutes the entire agreement between the parties and supersedes any and all previous agreements, memoranda, or other understandings of the parties. This agreement may be amended only in writing.[75]

The court dismissed such provision as a boilerplate integration clause intended to prevent either party from introducing parol evidence.[76] The court pointed out that although the clause stated that the distributorship agreement and the purchase orders constituted the entire agreement, it did not mean that they were one contract.[77] The court found that the language of the integration clause did not unify the purchase orders with the distributorship agreement.[78]

In the absence of express contractual language, courts have allowed offsets under §9-404 where separate contracts are so intertwined that they are effectively one agreement.[79] Courts may also consider the course of dealing between the parties. In cases where the parties have treated their transactions as a single contract, or a so-called "running account," the assignee of the account will be subject to offsets on the account.[80] In these cases, it appears to be a relevant factor if the secured party/assignee is aware of the course of dealing.[81]

IV. Bankruptcy

A. In general

Bankruptcy is both one of the most commonly invoked events of default and the event of default most feared by industry participants. This is understandable, as no other event of default possesses the inherent risks and raises the number of ancillary legal issues arising out of bankruptcy. From the non-defaulting party's perspective, bankruptcy is one of the least desirable events of default because it is regulated by the bankruptcy courts and limited by the Bankruptcy Code[82] and therefore contains inherent constraints to the non-defaulting party's rights that are not present with other events of default. The proper management of this event of default can mean the difference between immediately offsetting all obligations owed by a bankrupt defaulting party and receiving pennies on the dollar years down the road for the same obligations.

B. Automatic stay

The Bankruptcy Code contains an automatic stay provision that limits the actions a creditor may take against a bankrupt debtor.[83] The automatic stay prohibits a broad array of actions, including: (i) filing or continuing suit on any pre-petition action; (ii) enforcing any pre-petition judgment against the debtor; (iii) acting to obtain possession or exercise control over property of the bankrupt estate; (iv) creating, perfecting or enforcing a lien against the property of the bankrupt estate; (v) the setoff, netting or offset of pre-petition debts; (vi) the bankrupt party making payments on pre-petition obligations; and (vii) the termination of contracts with the bankrupt party.[84] The automatic stay is included in bankruptcy proceedings to protect debtors from creditors and to protect creditors from each other to ensure an orderly division of the bankrupt party's assets in a manner consistent with the Bankruptcy Code.[85]

1. Exemptions from the automatic stay

The Bankruptcy Code contains exemptions from the automatic stay for certain transactions, including forward contracts and swap contracts, permitting the termination, liquidation and exercise of rights of setoff with regard to such contracts.[86]

a. Forward contracts and swap agreements defined

A forward contract is

> "a contract (other than a commodity contract) for the purchase, sale, or transfer of a commodity . . . 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 transaction, reverse repurchase transaction, consignment, lease swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any combination thereof or option thereon."[87]

Although the Bankruptcy Code does not specifically state that contracts for the purchase and sale of natural gas or electricity are forward contracts, a recent court case has found that natural gas contracts are forward contracts.[88] However, it is assumed in industry contracts that electricity contracts will constitute forward contracts and parties often try to bolster this position by including a provision in energy trading contracts stating that the agreement is a forward contract.

A swap agreement is

> "(A) an agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, spot foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing); (B) any combination of

> the foregoing; or (C) a master agreement for any of the foregoing together with all supplements."[89]

This definition of swap agreement is sufficiently broad as to generally include any type of derivative transaction.

b. Importance of exemptions from the automatic stay

Exemptions from the automatic stay are important in the context of master agreements because they permit the early termination and liquidation of master agreements and the setoff of obligations without waiting for and obtaining bankruptcy court approval. These exemptions stem from: (i) the recognition that financial markets require the expenditure of large amounts of capital to generate a narrow profit margin; (ii) the fact that much of this capital is committed in reliance on the right to net the amounts owed between the parties; and[90] (iii) the potential for abuse if a bankruptcy trustee were permitted to cherry-pick transactions, *e.g.*, accept those transactions favorable to the bankrupt party and reject those that are unfavorable, particularly if the trustee is the debtor in possession.[91] The loss of this right would significantly impair the functioning of the commodity and financial markets and greatly reduce the liquidity of those markets.[92] If these transactions were not exempt from the automatic stay, "a party would not be able to unilaterally close out its market-sensitive contracts with a bankrupt counterparty, with the risk of unrecoverable losses and the potential for a domino chain of bankruptcies and receiverships affecting other commercial and financial institutions participating in the market."[93] However, despite the importance of this right, the Bankruptcy Code does not offer any affirmative right to terminate and liquidate forward and swap contracts but rather preserves any independently existing right the parties may otherwise so possess.[94]

Limitations to the exemptions to the automatic stay directly impact energy marketing and trading industry participants. While the Bankruptcy Code permits the setoff of any payments that arise out of any swap agreement,[95] it limits setoff under forward contracts to the setoff of margin payments or settlement payments arising out of forward contracts.[96] To broaden the forward contract setoff rights that are exempt from the automatic stay, some industry participants have inserted provisions into their master agreements stating that amounts owed under each agreement serve as collateral under every other agreement between the parties, thus recharacterizing all amounts owed between the parties as collateral. Although this strategy does not appear to have been approved by any court or regulatory body, its supporters suggest that its recent popularity among energy trading companies and the absence of any policy reason not to allow this practice lend weight to the theory of its enforceability.

Section 553(a) of the Bankruptcy Code recognizes a creditor's right to setoff amounts owed to a debtor against amounts owed to the creditor, provided: (i) all setoff amounts arose prior to the commencement of the bankruptcy proceeding; (ii) the obligations are enforceable under applicable law and are not otherwise subject to disallowance under the Bankruptcy Code; and (iii) the parties owe such amounts in the same capacity.[97] Parties are deemed to owe each other amounts in the "same capacity" when the amounts are owed in the parties' own names and not in a fiduciary capacity.[98] A creditor can file a motion for relief from the automatic stay and the Bankruptcy Court will typically rule on such a motion within thirty to sixty days. If the motion is denied, the creditor should be able to withhold payments to the debtor, thereby preserving the right of setoff,[99] but will not be able to exercise the right to book the setoff and apply the funds until the end of the bankruptcy proceeding, a delay that could be years in duration.

Whether or not the automatic stay applies is not determinative of whether the non-defaulting party possesses a right to setoff but rather of the timing of the exercise of such right. If the automatic stay applies, the non-defaulting party cannot effectuate any setoff until the bankruptcy court permits such actions to be taken. If a transaction is exempt from the automatic stay, the non-defaulting party may immediately take action without any delay on account of the bankruptcy proceeding.

C. Avoidance action claims

1. Preferences and fraudulent transfers

The most common types of avoidance actions are preferences and fraudulent transfers. A preference is a transfer of an interest of the debtor in property that: (i) is to or for the benefit of a creditor; (ii) is for or on account of pre-existing debt owed by the debtor before the transfer was made; (iii) is made while the debtor was insolvent; (iv) is made on or within ninety days of the bankruptcy filing date (or within one year of the bankruptcy filing date if the creditor was an insider at the time of the transfer); and (v) enables the creditor to receive more than it would receive if the bankruptcy case were a liquidation bankruptcy, the transfer had not been made and the creditor received payment to the extent provided by the Bankruptcy Code.[100] Preferences can take a variety of forms, including money payments, assignments, transfers of ownership, leases, mortgages, pledges, and the creation and perfection of liens.

a. Types of fraudulent transfers

There are two types of fraudulent transfers, those based on actual fraud and those based on constructive fraud. Actual fraud involves transfers or obligations incurred with actual intent to hinder, delay or defraud a current or future creditor.[101] Constructive fraud involves the transfer of an interest of the debtor in property, or the incurrence of any obligation by the debtor, in exchange for which the debtor received less than reasonably equivalent value and was insolvent on the date the transfer was made or the obligation was incurred, became insolvent as a result of the transfer or obligation, or was left with unreasonably small capital or intended or believed that it would incur debts beyond its ability to pay those debts as they mature.[102] The deadline for bringing suit to avoid a fraudulent transfer is generally considered to be four years from the date of the transfer or incurrence of the obligation at issue. Fraudulent transfers (actual or constructive) include all types of transfers and incurrences of obligations, including money payments, assignments, transfers of ownership, leases, mortgages, pledges, the creation and perfection of liens, and obligations arising out of promissory notes and other contracts.

b. *In re Olympic Natural Gas Company*

The issue of avoidance actions was recently addressed by a Houston bankruptcy court and affirmed by the Fifth Circuit Court of Appeals in In re Olympic Natural Gas Company in the context of whether payments for forward contracts between energy trading companies constitute impermissible transfers.[103] Morgan Stanley and Olympic entered into four transactions for the sale of gas by Morgan Stanley to Olympic on a daily basis in February, March and April 1997. Olympic paid Morgan Stanley in April and May 1997 for the gas previously delivered. Olympic entered bankruptcy in June 1997. The Trustee for Olympic sued Morgan Stanley for the return of the April and May payments on the grounds that they constituted preferential and/or fraudulent transfers. The court ruled that these payments were settlement payments pursuant to 11 U.S.C. 546(e) and therefore could not be avoided by the Trustee.[104] This case provides support for the proposition that the threat of possible avoidance actions should not affect the normal payment practices used by energy trading and marketing companies.

c. Avoidance actions and swap agreements

The Bankruptcy Code also protects swap agreements from attack as preferences of fraudulent transfers. Absent fraudulent intent, "the trustee may not avoid a transfer under a swap agreement, made by or to a swap participant, in connection with a swap agreement and that is made before the commencement of the case"[105] unless the transfer was made "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted."[106] Fraudulent transfers can also exist if the bankrupt entity

> "received less than a reasonably equivalent value in exchange for such transfer or obligation; and (i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured."[107]

However, the Bankruptcy Code provides that "a swap participant that receives a transfer in connection with a swap agreement takes for value to the extent of such transfer"[108] and, therefore, absent fraudulent intent, payments related to swap agreements should be immune from attack as fraudulent transfers.

D. Ipso facto provisions

Ipso facto provisions allow for the automatic or proactive termination or modification of a contract solely because of a provision in the contract that is conditioned on: (i) the insolvency or financial condition of the debtor at any time before the closing of the bankruptcy case; (ii) the commencement of a bankruptcy case; or (iii) the appointment of a trustee after the commencement of the bankruptcy case, or the appointment of a custodian before the commencement of a bankruptcy case.[109] As a general rule, ipso facto provisions in a contract are unenforceable. However, an exception to this rule permits the exercise of ipso facto provisions to terminate and liquidate forward contracts and swap agreements.[110] As a result, the remedies available to a non-defaulting party may be curtailed if the event of default is the bankruptcy of the defaulting party rather than an event of default unrelated to insolvency.[111] Because of this limitation on ipso facto clauses, a non-defaulting party may wish to cite events of default instead of or in addition to the bankruptcy proceeding, as the ipso facto restriction does not limit the exercise of contractual remedies arising from occurrences other than the commencement of a bankruptcy proceeding.[112]

V. Conclusion

The recent and ongoing turmoil in the energy trading markets has caused justifiable concern as to the future risks associated with continued participation in these markets. A valuable tool in managing such risks is the inclusion of early termination and liquidation provisions in all master agreements. Despite their widespread use and acceptance, pitfalls do exist in the use of these provisions, and companies are advised to consult with their legal advisors before relying on these provisions.

Appendix A

	ISDA	EEI	WSPP
EVENTS OF DEFAULT			
Failure to make payment	X	X	X
Breach of agreement	X		
Credit support default	X		
Misrepresentation	X	X	
Default under specified transaction	X		
Cross Default	X	X	
Bankruptcy	X	X	X
Merger without assumption	X		
False warranty		X	X
Failure to perform material covenant or obligation		X	
Failure to satisfy creditworthiness/collateral		X	X
Transfer entity fails to assume obligations		X	
Party's Guarantor:		X	
False/misleading representation or warranty		X	X
Failure to make payment/perform material		X	X
covenant/obligation		X	X
Guarantor becomes bankrupt		X	X
Failure of guaranty to be in full force & effect		X	X
Guarantor repudiates (etc.) guaranty		X	X
TERMINATION EVENTS			
Illegality	X		
Tax Event	X		
Tax event upon merger	X		
Credit event upon merger	X		

[1] Examples of commonly used standardized master agreements include the ISDA (International Swap Dealers Association, Inc., Master Agreement), NAESB (North American Energy Standards Board Base Contract for Sale and Purchase of Natural Gas), GISB (Gas Industry Standards Board Base Contract for Short-Term Sale and Purchase of Natural Gas), EEI (Edison Electric Institute Master Power Purchase and Sale Agreement), GasEDI (GasEDI Base Contract for Short-Term Sale and Purchase of Natural Gas), and WSPP (Western Systems Power Pool Agreement).

[2] *In re Enron Corp*., No. 01-16034 (Bankr. S.D.N.Y. Dec. 2, 2001).

[3] *E.g.*, Susan Kellogg, *Aquila Quits Energy-Trading Business*, *available at* http://www.energyinfosource.com/commentary/article.cfm?articleID=86 (last visited October 2, 2002).

[4] While most master agreements contain liquidated damages provisions, the ISDA lacks a liquidated damages provision because the ISDA does not contemplate physical delivery.

[5] *See* U.C.C. § 2-712. *See also* JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS § 14.20, at 570 and n.2 (4th ed. 1998). *See, e.g.*, EEI § 4, at 13, GISB § 3, at 4, NAESB § 3, at 4, GasEDI § 3, at 6.

[6] *See* Texas Business and Commerce Code § 2.713.

[7] *Id. See, e.g.*, GISB § 3.2, at 4, NAESB § 4.3, at 5, GasEDI § 3.2, at 6. Spot prices usually refer to industry publications such as Gas Daily or Megawatt Daily, but any objective price reporter can be used.

[8] *Id.*

[9] *See User's Guide to the 1992 ISDA Master Agreements,* § II.F.

[10] *See* International Swaps and Derivatives Association, Inc., Who we are - Mission, at http://www.isda.org/wwa/index.html (last visited August 25, 2002). The need for a standard swap agreement arose prior to the deregulation of the United States energy markets. The result was the formation of the International Swap Dealers Association ("ISDA") in 1984. ISDA is a trade association composed of dealers and market participants engaged in transactions in the OTC derivative markets. ISDA produces standard form documentation for privately negotiated derivative contracts with terms specifically tailored to the specific needs of the parties. ISDA currently produces the following documents: (i) the 2000 ISDA Definitions; (ii) the 1992 Master Agreement; (iii) the User's Guide to the 1992 Master Agreement, drafted in 1993, explaining in detail each section of the 1992 Master Agreement; (iv) the Commodities Derivatives Definitions, drafted in 1993 and supplemented in 2000; and (v) the Annex, providing for collateral documentation, finalized in 1994, followed by its User's Guide in 1995.

[11] *See User's Guide to the 1992 ISDA Master Agreements*, International Swap Dealers Association, Inc., 1993 Edition, § I.B.2., p.8.

[12] *E.g.*, the GISB lacks early termination and liquidation provisions unless parties agree to add such provisions as special provisions, while the EEI contains the provisions in its standard form.

[13] *E.g.*, a failure to make payment under the EEI and ISDA does not become an event of default unless such failure to pay continues for three business day after the other party provides notice of such failure. Under the NAESB, failure to make payment on or before the second business day following written notice constitutes an event of default.

[14] *See* ISDA § 5(b). Although termination events per se are only found in the ISDA, analogous provisions are often negotiated into other master agreements to address the same issues as those addressed in the ISDA.

[15] *Id.*

[16] *See User's Guide to the 1992 ISDA Master Agreements,* § I.F.3.

[17] *See* ISDA § 6(b).

[18] *See* ISDA § 5(b).

[19] *See, e.g.*, EEI § 5.2 and ISDA § 6(a).

[20] Any such agreement would likely relate to performance assurance and/or other agreements between the parties and/or their affiliates. This is often the case when the other contracts lack early termination and liquidation rights and the non-defaulting party is exposed to the defaulting party under these other agreements.

[21] *See* § 10.1 of the NAESB, § 2.1 of the GasEDI, § 5.1 of the EEI, § 5(a) of the ISDA, Paragraph 7 of the ISDA Credit Support Annex.

[22] *See* ISDA § 5(b).

[23] *See* ISDA § 5(a)(vi).

[24] *E.g.*, Enron filed for bankruptcy on December 2, 2001, and the total amount of its payment defaults is still unclear as of November 1, 2002, as are the precise amounts of its payment defaults to individual counterparties.

[25] Some master agreements place a cap on the maximum amount of time that may elapse between the notice of an event of default and the early termination date. *See, e.g.,* EEI § 5.2 and ISDA § 6(a).
[26] *Id.*
[27] ISDA § 6(a).
[28] *See User's Guide to the 1992 ISDA Master Agreements* at 21.
[29] *See, e.g.*, ISDA § 6(c)(ii) and EEI §§ 5.2, 5.6 and 5.7.
[30] *See infra* § IV.D.
[31] A provision in a master agreement listing the remedies upon early termination might read as follows: "If at any time an event of default with respect to a defaulting party has occurred and is continuing, the non-defaulting party may do one or more of the following: (a) withhold any payments due to the defaulting party under this Agreement; (b) suspend performance due to the defaulting party under this Agreement; and/or (c) by giving not more than twenty (20) days notice, designate a day not earlier than the day such notice is effective as an early termination date."
[32] *See, e.g.*, EEI § 5.2 and NAESB § 10.3.
[33] *E.g.*, "To the extent that in the reasonable opinion of the non-defaulting party certain of such terminated transactions are commercially impracticable to liquidate and terminate or may not be liquidated and terminated under applicable law on the early termination date, then each such transaction shall be terminated as soon thereafter as reasonably practicable."
[34] *See, e.g.*, EEI § 5.3 and ISDA § 6(e)(i).
[35] *See, e.g.*, the definition of "Market Quotation" in § 14 of the ISDA.
[36] This is often referred to as the "spot" standard.
[37] This is often referred to as the "cover" standard.
[38] Some agreements provide for loss as the fallback method in the event market quotation is an impractical measure. *See, e.g,*, the definition of "Settlement Amount" in § 14 of the ISDA.
[39] *See, e.g.*, the definition of "Loss" in § 14 of the ISDA.
[40] This is referred to as the Termination Payment in the EEI, the Settlement Amount in the ISDA and the Net Settlement Amount in the NAESB, and referred to herein as the "Settlement Amount."
[41] Also referred to in the ISDA as First Method and Second Method. *See* ISDA § 6(e)(i).
[42] *Drexel Burnham Lambert Products Corp. v. Midland Bank PLC*, 1992 U.S. Dist. LEXIS 21223 (S.D.N.Y. Nov. 10, 1992), appeal dismissed per stipulation. It is worth noting that the trial court cited no precedent for its decision, no appellate court has ever ruled on this decision and this case has never been cited as authority in any other decision. In light of these facts, this case is of dubious precedential value.
[43] *E.g.,Amtorg Trading Corp. v. Miehle Printing Press & Mfg. Co.* , 206 F.2d 103, 105-06 (2d Cir. 1953); *Hewitt School v. Mellon*, 505 N.Y.S.2d 366, 367-368 (N.Y. Civ. Ct. 1986).
[44] *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528 (1913).
[45] *User's Guide to the 1992 ISDA Master Agreements*, Sec. V.
[46] Under Texas law, setoff is a procedural right. *Reed v. Israel Nat. Oil Co., Ltd.*, 681 S.W.2d 228 (Tex.App.-Houston [1st Dist.] 1984, no writ). Under New York law, setoff is a common law right. *In re Bennett Funding Group, Inc.*, 146 F.3d 136, 140 (2d Cir. 1998); *see also 3 Lafayette Avenue Corp. v. Comptroller of the State of New York*, 587 N.Y.S.2d 456, 457 (N.Y. App. Div. 1992). New York has also created a statutory right "to set off and apply against any indebtedness, whether matured or unmatured, of such creditor to such debtor, any amount owing from such debtor to such creditor, at or at any time after . . . the filing of a petition under any of the provisions of the federal bankruptcy act . . . ." N.Y. DEBT. & CRED. LAW § 151 (McKinney 1997).
[47] *Parker v. Moore Grocery Co.*, 107 S.W.2d 1083 (Tex.Civ.App. - Beaumont 1937, no writ).
[48] *E.g.*, if two parties have entered into GISB, EEI and ISDA agreements, the non-defaulting party would setoff obligations under all three agreements to arrive at a single net sum rather than confining the setoff to each agreement and creating three separate payment obligations.
[49] *See* 11 U.S.C. § 362(b)(6) and 11 U.S.C. § 362(b)(17).
[50] "[T]he better interpretation of section 362(b) is that it protects cross-product netting." 5 *Collier on Bankruptcy*, §556.05[2] at 556-13 (15th Edition Rev. 2002).
[51] Financial Contract Netting Improvement Act of 2001, H.R. 11, 107th Cong. (2001).
[52] *See, infra* § 4(b).
[53] Some parties also feel that this provision ensures the setoff right will receive priority over any security interest in the same receivables. Parties should ensure that their use of this provision does not conflict with any previous pledges of the receivables or any negative covenants addressing such pledges.
[54] *See* 11 U.S.C. 362(b)(6) referencing "other property held by or due from such . . . forward contract merchant . . . to secure . . . forward contracts."

[55] *See, e.g, Depositors Trust Co. of Augusta v. Frati Enter., Inc.*, 590 F.2d 377, 379 (1st Cir. 1979). But *also see Bloor v. Shapiro*, 32 B.R. 993, 1001-1002 (S.D.N.Y. 1983) permitting the assertion of triangular setoff rights by a guarantor against a bankrupt debtor to the guaranteed parties.
[56] *See In re Custom Coals Laurel*, 258 B.R. 597, 607 (Bankr. W.D. Pa. 2001) citing *In re Lang Machinery Corp.*, 1988 Bankr. LEXIS 1667 (Bankr. W.D. Pa. 1988) ("For a valid 'triangular' setoff to exist, Debtor must have formally agreed to permit aggregation of debts by two creditors"); *In re Hill Petroleum Co.*, 95 B.R. 404, 411 (Bankr.W.D. La. 1988) ("The narrow exception to the rule against three party, 'triangular' set offs, occurs when there is a formal agreement by the debtor that two entities may aggregate debts owed to and from the debtor [4 *Collier on Bankruptcy* § 553.04[2] at 553-19 (1988)], *In re Berger Steel Co., Inc.*, 327 F.2d 401 (7th Cir. 1964)); *In Re Balducci Oil Company, Inc* , 33 B.R. 847, 853 (Bankr. D.Colo. 1983) ("However, the courts interpreting the term 'mutual debts' have carved an exception to the general rule in the 'triangular tradeoff situation.' The courts have found mutuality between three parties, as a matter of contract law, where there was an express contractual agreement clearly evincing the intent of the parties to treat the parent and subsidiary as one entity"); *In re Fasano/Harriss Pie Co.*, 43 B.R. 864, 870-71 (Bankr.W.D.Mich. 1984), *aff'd* 70 B.R. 285 (W.D. Mich. 1987) ("The courts have found mutuality between three parties, as a matter of contract law, where there was an express agreement clearly evidencing the intent of the parties to treat the related corporations as a single entity [citing Balducci,*supra*]."). A Texas court has recently held that contractual triangular setoff rights are enforceable, but only to the pro rata share of each affiliate's portion of the aggregate liability. *In re Enron Corp.*, No. 01-16034 (Bankr. S.D.N.Y. Dec. 2, 2001). The precedential weight of this decision is at present uncertain as the matter is presently under appeal to the 5th Circuit Court of Appeals.
[57] 5 *Collier on Bankruptcy*, § 553.03[3][b] at 553-30 (15th Ed. Rev. 2002) (citations omitted).
[58] It is increasingly common for energy marketing and trading companies to divide affiliated companies by product (*e.g.*, a natural gas trading company and a power trading company), geography (*e.g.*, a United States trading company and a Canadian trading company), the intended counterparty to a transaction (*e.g.*, a wholesale trading company and a retail trading company), or governmental regulation (*e.g.*, a regulated natural gas pipeline and an affiliated natural gas trading company).
[59] This is due to the practice of assigning an aggregate unsecured credit limit to a counterparty based on the creditworthiness of the parent guarantor. Because trading companies are often thinly capitalized, they rely on rated parents for the extension of credit from trading counterparties. When a credit threshold is assigned based on a single parent entity and is then spread among various affiliates, it is beneficial for the other party to maintain rights of setoff against all of the counterparty's affiliates both individually and across each other in order to manage the unsecured credit line as a single, aggregate number. If triangular setoff is not permitted and each affiliate must be allocated credit on an individual basis, not permitting setoff across its affiliates, the amount of available credit will significantly decrease. *E.g.*, Party A1 and its affiliates A2 and A3 all trade with Party B. Party B assigns an unsecured credit line based on the strength of the guarantor of the Party A1, A2 and A3 parties of $30 million. If triangular setoff is permitted, these three affiliates may be flexible in the use of this unsecured credit line and are not required to establish an individual limit for each affiliate so long as the aggregate limit is not exceeded. In contrast, if triangular setoff is not permitted, the aggregate unsecured credit line would be apportioned among the affiliates and an affiliate would not be permitted to use the unsecured credit line of its affiliate without the express consent of the other party. If triangular setoff is permitted, at any given time A1 could use $20 million of the credit line, A2 could use $7 million and A3 could use $3 million. If the trading positions of the affiliates changed, the affiliates could adjust their allocation of the credit line so A1 used $15 million, A2 $5 million and A3 $10 million without the consent of Party B or any written documentation of this changed allocation. If triangular setoff is not permitted, and the affiliates were each allocated an equal share of the credit line, A1 could not increase its allocation to $15 million without the consent of Party B and written documentation adjusting the credit line, even if Part A3 only used $5 million of the $10 million credit line it was allocated.
[60] 11 U.S.C. § 362(b)(6).
[61] 11 U.S.C. § 362(b)(17).
[62] *See, e.g., Fleet Capital Corp. v. Yamaha Motor Corp., U.S.A.*, 2002 U.S. Dist. LEXIS 18115 (S.D. N.Y. 2002); *Chase Manhattan Bank, N.A. v. State*, 357 N.E.2d 366, 368-69 (N.Y. 1976).
[63] *Chase Manhattan Bank*, 357 N.E.2d at 369.
[64] *In re Apex Oil Co.*, 975 F.2d 1365, 1368-1369 (8th Cir. 1992); *Fleet Capital Corp.*, 2002 U.S. Dist. LEXIS 18115, 94 n.35 (stating that "although Article 9 usually refers to a creditor with a security interest as a "secured party," a secured party with a security interest in accounts is the "assignee" under . . . §9-318").
[65] *In Apex Oil Co.*, 975 F.2d at 1369.
[66] *Id*.

[67] *Conoco, Inc. v. Amarillo Nat'l Bank*, 950 S.W.2d 790, 797 (Tex.App.—Amarillo 1997, writ granted), *overruled on other grounds*, 996 S.W.2d 853 (Tex. 1999).
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] *See, e.g., Interfirst Bank Dallas, N.A. v. United States Fidelity and Guar. Co.*, 774 S.W.2d 391, 397-98 (Tex. App.—Dallas 1989, writ denied) (applying §9-318(a) to determine a priority dispute between a subcontractor's surety and a secured party lender with a security interest in the subcontractor's account); *Bank One, Texas, N.A. Communication Specialists, Inc.*, 813 S.W.2d 755, 757 (Tex. App.—Texarkana 1991, no writ) (recognizing a secured party lender with a security interest in an account as an "assignee" for purposes of §9-318(b)); *Citizens State Bank of Corrigan v. J.M. Jackson Corp.*, 537 S.W.2d 120, 121 (Tex.App.—Houston [14th Dist.] 1976, no writ) (recognizing a secured party lender with a security in an account as an "assignee" for the purposes of §9-318(c)); *Manes Construction Co., Inc. v. Wallboard Coatings Co., Inc.*, 497 S.W.2d 334, 336-37 (Tex. App.—Houston [14th Dist] 1973, no writ) (recognizing the grant of a security interest in an account as an assignment of such account for purposes of §9-318(c)).
[72] *In re Apex Oil Co.*, 975 F.2d at 168-169; *Fleet Capital Corp.*, 2002 U.S. Dist. LEXIS 18115, 94-99; *Chase Manhattan Bank*, 357 N.E.2d at 368-370.
[73] *Chase Manhattan Bank*, 357 N.E.2d at 369.
[74] *Harris v. Dial Corp.*, 954 F.2d 990, 993 (4th Cir. 1992).
[75] *Echo, Inc. v. The Whitson Co., Inc.*, 52 F.3d 702, 706-707 (7th Cir. 1995).
[76] *Id*. at 707
[77] *Id*.
[78] *Id*.
[79] *Harris v. Dial Corp.*, 954 F.2d at 993.
[80] *See Fleet Capital Corp.*, 2002 U.S. Dist. LEXIS 18115, 102 (including cases cited therein).
[81] *Id.*
[82] 11 U.S.C. § 101 *et seq.*, herein "Bankruptcy Code".
[83] 11 U.S.C. §362(a).
[84] 11 U.S.C. §362(a).
[85] "[The automatic stay] has two broad purposes. First, it provides debtors with protection from hungry creditors: 'It gives the debtor a breathing spell from its creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.' H.R. Rep. No. 595, 95th Cong., 1st Sess., at 340 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6296-7. Second, the stay assures creditors that the debtor's other creditors are not racing to various courthouses to purchase independent remedies to drain the debtor's assets: 'The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors.'" *Dean v. Trans World Airlines, Inc.*, 72 F.3d 754, 755-56 (9th Cir. 1995), *cert denied*, 117 S. Ct. 169 (1997).
[86] 11 U.S.C. §§362(b)(6), 546(e), 555, 556 (addressing commodity and forward contracts); 11 U.S.C. §§362(b)(17), 546(g), 560 (addressing swaps). Please note that some concern exists that these provisions may not be enforceable in a proceeding under Chapter 9 of the Bankruptcy Code filed by a municipality.
[87] 11 U.S.C. § 101(25).
[88] *In re Olympic Natural Gas Company*, 258 B.R. 161, 164-65 (Bankr. S.D. Tex. 2001),Aff'd 294 F.3d 737 (5th Cir. 2002). Physical commodity contracts, specifically gas, are "eligible financial contracts" under Canadian law, a status analogous to forward contracts under U.S. laws. *In re Blue Range Resource Corporation*, 2000 ABCA 239 (Ct. of Appeal Alberta).
[89] 11 U.S.C. § 101(53B).
[90] Courts have "recognized that derivative contracts are a legitimate method of managing risk and as a matter of public policy should not be dealt with in a manner that affects their efficiency either in non-solvency or insolvency situations. 'If the right to terminate contemplated in the agreement . . . is not enforceable, the whole structure of risk management for the swaps and other transactions is weakened or may fall apart.'" *Id.* at para. 27, citing *Confederation Treasury Services Ltd. (Trustee of) v. Hees International Bancorp Inc.*, 45 C.B.R. (3d) 204 (Ont. Gen Div. 1977).

> "Quite apart from the unfairness of cherry-picking, other undesirable consequences follow. In order to determine credit availability, risk management companies

account for "out of the money" transactions by deducting the value of "in the money" transactions. This practice is only appropriate if termination and netting out provisions are enforceable, and unaffected by an insolvency. If forward gas contracts are not exempt from the … stay provisions and no offsetting deductions are permitted, available credit will quickly be gobbled up. As a result, risk management companies will limit the capital they can allocate to the market, or ask cash- strapped [*sic*] gas producers to put up additional security to cover any short-falls [*sic*]. The unfortunate effect will be reduced availability of physical forward gas sales contracts to small producers, who are most in need of hedges to manage price risks."

Id. at para. 30. Although *Blue* Range lacks precedential value in the United States, its reasoning is important because Canadian law relating to insolvency and the exemption for forward and swap agreements from the automatic stay provisions has been intentionally drafted to closely follow United States law. *Id.* at para. 8.

[91] As described by a Canadian bankruptcy court, a bankrupt party may "terminate and breach contracts with impunity, forcing the non-defaulting party to claim damages as an unsecured creditor in the [bankruptcy] proceedings. The ability to selectively repudiate contracts is disdainfully known as 'cherry-picking'. The debtor company could, for example, retain 'out of the money' transactions, speculating that they might improve in value, but knowing full well that it would not be able to pay if the market moved in the other direction. At the same time it might terminate "in the money" transactions, triggering a cash payment by the non-defaulting party." [citation omitted]. *In re Blue Range Resource Corporation*, at para. 28. Some master agreements, including the EEI, attempt to address the risk of cherry-picking in a bankruptcy proceeding by including a provision stating that the master agreement and all transactions are a single agreement.

[92] "Without enforceable termination and netting out provisions, the insolvent company maintains complete control and may repudiate a contract at any time without notice. Because the non-defaulting party cannot count on performance, it cannot effectively re-hedge its risk by entering into an offsetting contract incorporating similar terms. Given the volatility of the market, the non-defaulting party is exposed to excessive and unmanageable risk." [Footnote deleted]. *Id.* at para. 29.

[93] Edison Electric Institute, *Survey of the Legal Landscape Applicable to Master Netting Agreements*, October 25, 20002 draft, *available at* http://www.eei.org/issues/contract/mna/legal_landscape_10-25-O2.pdf (*last visited November 7, 2002).*

[94] *See* 11 U.S.C. 553; *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18, 116 S.Ct. 286, 289, 133 L.Ed.2d 258 (1995); *In re Bennett Funding Group, Inc.*, 146 F.3d 136, 138-39 (2d Cir. 1998). This illustrates the importance of proper contract drafting, as a party will have no rights to terminate and liquidate forward and swap contracts regardless of the provisions of the Bankruptcy Code if this right is not specifically created in the contract.

[95] 11 U.S.C. § 362(b)(17), which references mutual debts, and 11 U.S.C. § 560, which does not reference debts.

[96] 11 U.S.C. § 362(b)(6), which references mutual debts.

[97] "Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . ." 11 U.S.C. § 553(a).

[98] *In re Westchester Structures, Inc.*, 181 B.R. 730, 739 (Bankr. S.D.N.Y. 1995).

[99] 11 U.S.C. § 542(b).

[100] 11 U.S.C. § 547(b).

[101] 11 U.S.C. § 548(a)(1)(A).

[102] 11 U.S.C. § 548(a)(1)(B).

[103] *In re Olympic Natural Gas Company*, at 165-66.

[104] *Id.* at 166.

[105] 11 U.S.C. § 546(g).

[106] 11 U.S.C. § 548(a)(1)(A).

[107] 11 U.S.C. § 548(a)(1)(B).

[108] 11 U.S.C. § 548(s)(2)(D).

[109] 11 U.S.C. § 365(e)(1).

[110] 11 U.S.C. § 556 (forward contracts) and 11 U.S.C. § 560 (swap agreements).

[111] An example of an ipso facto provision is the right in Section 6(c)(ii) of the ISDA of the non-defaulting party to suspend payment to the defaulting party upon the occurrence of an event of default. While this is permissible for

any non-bankruptcy event of default, this is an impermissible ipso facto provision if the event of default is the bankruptcy of the defaulting party.

[112] *E.g.*, a provision in a master agreement permitting a non-defaulting party to withhold payment upon the occurrence of an event of default would be enforceable if the event of default was a failure to make payment but not if the event of default was the bankruptcy of the defaulting party.