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Memorandum

To: The Commodity Futures Trading Commission

From: Cadwalader, Wickersham and Taft LLP

Date: March 20, 2013

Re: Legal Basis for Setoffs By Electric Reliability Council of Texas, Inc. as Central Counterparty

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The Electric Reliability Council of Texas, Inc. ("ERCOT") has adopted a central counterparty model in which it would be a counterparty to market participants on all transactions made in the ERCOT market. ERCOT asked us to prepare a memorandum assessing whether the designation of ERCOT as a central counterparty for pool transactions in ERCOT markets satisfies the mutuality condition necessary to assert setoff rights in the event of the bankruptcy of an ERCOT market participant under Title 11 of the United States Code (the "Bankruptcy Code").[1]

We are providing this memorandum to you for information purposes only in connection with ERCOT's Application for an Exemptive Order Under Section 4(c) of the Commodity Exchange Act. As part of its consideration of the Application, the CFTC may post a complete copy of this memorandum on its website.

I. Setoff Rights Under the Bankruptcy Code

A. Protection of and Limitation on Setoff Rights

"Setoff" is a right that arises under state law or under a contract that "allows entities that owe each other money to apply their mutual debt against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'"[2] As explained by a noted bankruptcy treatise,

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[1] Based on the attached certification of ERCOT, we understand that ERCOT has completed Nodal Protocol Revision Request 458 ("NPRR"), Establishment of ERCOT's Central Counterparty Role, revising the Protocols in order to reflect the new central counterparty status of ERCOT. The NPRR was approved by the ERCOT Board of Directors in July, 2012, effective January 1, 2013. As further confirmed by the certification, the revised Protocol provides that ERCOT will engage in transactions with market participants as a principal, and will take title to power delivered by market participants.

[2] *In re Gordon Sel-Way, Inc.*, 270 F.3d 280, 290 (6th Cir. 2001) (quoting *Citizens Bank of Md.* v. *Strumpf*, 516 U.S. 16, 18 (1995)).

"A right of setoff is a remedy that has long been recognized and enforced in the commercial world at large, as well as under every one of the nation's bankruptcy acts."[3] Such rights help "avoid a multiplicity of suits, added expense, inconvenience, injustice and inefficient use of judicial resources."[4]

Section 553 of the Bankruptcy Code accordingly provides that the commencement of a case under the Code "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."[5] Indeed, the Bankruptcy Code treats claims of creditors having the benefit of enforceable rights of setoff against amounts owing to the debtor as "secured claims"[6] (secured, in effect, by the value of the claim the debtor holds against the creditor).

Section 553 of the Code does not create an independent right of setoff. It merely preserves state-law rights that otherwise satisfy the requirements of the section.[7] Every state recognizes setoff, either by common law or statute, including Texas. *Bandy v. First State Bank*, 835 S.W. 2d 609 (Sup. Ct. TX 1997).

In addition to the need for an underlying state law right of setoff, Section 553 and the caselaw interpreting it make clear that setoff rights are only enforceable subject to certain qualifications and exceptions. Merely satisfying the state-law requirements is insufficient to assert setoff in bankruptcy; the creditor must satisfy the *additional* requirements outlined in section 553.[8] Specifically, a creditor may assert a right of setoff under section 553 only if the following conditions are met: "(1) the creditor holds a 'claim' against the debtor that arose before the commencement of the case; (2) the creditor owes a 'debt' to the debtor that also arose before the commencement of the case; (3) the claim and debt are 'mutual;' and (4) the claim and debt are each valid and enforceable."[9]

B. The Mutuality Requirement

While the Bankruptcy Code does not define "mutual," courts have developed a test for determining whether mutuality exists. Debts are mutual when: (i) the debts and credits are

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3 5 *Collier on Bankruptcy* ¶ 553.02 (16th ed. 2010).

4 5 *Collier on Bankruptcy* ¶ 553.01 (16th ed. 2010).

5 11 U.S.C. § 553

6 11 U.S.C. § 506(a)(1).

7 *In re Chateaugay Corp.*, 94 F.3d 772, 777 n.5 (2d Cir. 1996); *In re Bevill, Bresler & Schulman Asset Management Corp.*, 896 F.2d 54, 57 (3d Cir. 1990).

8 *See In re County of Orange*, 183 B.R. 609, 615 (Bankr. C.D. Cal. 1995).

9 5 *Collier on Bankruptcy* ¶ 553.03 (15th ed. 2008).

between the same parties; (ii) the debts and credits are in the same right; and (iii) the parties are standing in the same capacity.[10]

(1) "Between the Same Parties"

Eligibility for setoff requires that the obligations be between the same two parties, *i.e.* A owes B, and B owes A. This rule is often used to deny setoff in "triangular setoff" situations.[11] In a "triangular setoff," A owes a debt to B who owes a debt to C, and A attempts to offset its debt to B against B's debt to C.[12] This situation frequently arises when a parent company (*i.e.*, A) seeks to offset its obligations to the debtor (*i.e.*, B) against the debtor's obligations to the parent's subsidiary (*i.e.*, C), or when a non-debtor seeks to offset its obligations to a debtor by the amount of the non-debtor's claim against the debtor's also-bankrupt subsidiary.[13] "It is a matter of well settled law . . . that debts involving parent and subsidiary business entities are not mutual for [s]ection 553 purposes."[14] Furthermore, "[a] 'control' relationship does not . . . necessarily make two entities a single entity for setoff purposes."[15]

(2) "In the Same Right" and "In the Same Capacity"

While courts sometimes use the "in the same right" and "in the same capacity" requirements interchangeably, "in the same right" means that a claim that is owned jointly with another party is generally not eligible for setoff.[16] The purpose of this requirement is to protect an innocent third party holder of a claim. For instance, Creditor A and Creditor B own a joint claim against Debtor D. Meanwhile, Creditor A owes a debt to Debtor D. Creditor A may wish to offset its obligations against D's obligation to both A and B. Allowing A to assert a setoff right, however, would harm Creditor's B's interest in the joint claim.

The "capacity" requirement means that mutuality is lacking if the parties "stand in *different relationships* in the various transactions."[17] "The distinction between the concept of

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[10] *In re Westchester Structures, Inc.*, 181 B.R. 730, 739 (Bankr. S.D.N.Y. 1995); 5 *Collier on Bankruptcy* ¶ 553.03 (15th ed. 2008).

[11] *See, e.g.*, *In re Lehman Brothers Inc.*, 458 B.R. 134, 141-42 (Bankr. S.D.N.Y. 2011).; *In re SemCrude L.P.*, 399 B.R. 388 (D. Del. 2009); *In re Hill Petroleum Co.*, 95 B.R. 404, 411-12 (Bankr. W.D. La. 1988).

[12] 5 *Collier on Bankruptcy* ¶ 553.03 (15th ed. 2008); *see also Depositors Trust Co. of Augusta* v. *Frati Enterprises*, 590 F.2d. 377, 379 (1st Cir. 1979); *In re Balducci Oil Co.*, 33 B.R. 847, 852-53 (Bankr. D. Colo. 1983).

[13] 5 *Collier on Bankruptcy* ¶ 553.03 (15th ed. 2008).

[14] *In re Sentinel Prods. Corp.*, 192 B.R. 41, 47 (Bankr. N.D.N.Y. 1996).

[15] *In re County of Orange*, 183 B.R. 609, 616 (Bankr. C.D. Cal. 1995).

[16] 5 *Collier on Bankruptcy* ¶ 553.03 (15th ed. 2008). *See, also, Gray v. Rollo,* 85 U.S. 629 (1873) (mutuality is lacking where a partnership has a claim against an individual, but the individual has a claim against only one of the partners). However, some courts have interpreted "in the same right" to mean that a "pre-petition debt cannot offset a post-petition debt." *See In re Westchester Structures, Inc.*, 181 B.R. 730, 739 (Bankr. S.D.N.Y. 1995). Despite the different interpretations of "in the same right," it appears that courts are in agreement that: (i) a pre-petition debt cannot offset a post-petition debt; and (ii) jointly held claims are generally not eligible for setoff.

[17] *In re Westchester Structures, Inc.*, 181 B.R.at 739 (emphasis in original).

'capacity' and the requirement that the obligations be owed between the 'same parties' is that the latter refers to the identity of the parties whereas the former refers to their relationship to each other."[18] Thus, setoff has been disallowed where the creditor sought to setoff its own obligations against funds that he held in trust for another party.[19] Setoff likely would also be disallowed where one party acts as an agent. For example if A owes a debt to B, and B, as agent for one or more others, owes a debt to A, the debts are not likely to be considered mutual.

II. Transactions Among ERCOT and Market Participants.

For purposes of this memorandum, we are assuming certain facts, certified to by ERCOT, as follows:

ERCOT is a Public Utility Commission of Texas-certified ISO, charged with providing non-discriminatory, open access electricity and transmission services in the ERCOT region.[20] The Public Utility Regulatory Act ("PURA") of Texas mandated the establishment of an ISO in the ERCOT region.[21] ERCOT maintains a Real Time Market ("RTM") and a Day Ahead Market ("DAM"). In addition, ERCOT conducts monthly and annual auctions for the purchase and sale of congestion revenue rights ("CRRs").[22]

ERCOT's revised Protocols provide that ERCOT is the counterparty to each transaction executed by a participant in the RTM, DAM and CRR markets. ERCOT will be a buyer to each market seller, taking title to electricity and other products delivered, and a seller to each market buyer, assuming liability for payables, in its own name and right.

III. Effectiveness of a Central Counterparty in Establishing Setoff Rights

A. Generally

There is general consensus in the legal community, both in the United States and in England and other systems deriving from English law, that central counterparty systems create enforceable setoff rights:

> If a central counterparty is used, all trades between market members are deemed to be trades with the clearing-house as principal. . . . The effect is that all trades which a defaulting member would otherwise have had with other members—and which could not be netted on insolvency because of

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[18] 5 *Collier on Bankruptcy* ¶ 553.03 (15th ed. 2008).

[19] *In re Bevill, Bresler & Schulman Asset Management Corp.*, 896 F.2d at 57; *In re Texas Mortgage Services Corp.*, 761 F.2d 1068, 1075 n.11 (5th Cir. 1985); *Modern Settings, Inc.* v. *Prudential-Bache Securities, Inc.*, 936 F.2d 640, 648 (2d Cir. 1991) (no mutuality where the creditor's debt arose from its breach of a fiduciary duty to the debtor, even though the creditor was not a "technical trustee").

[20] *See* Protocols § 1.2.

[21] PURA § 39.151.

[22] Protocols § 7.5. CRRs are also commonly known as financial transmission rights or FTRs.

> the lack of mutuality—become instead trades between the defaulter and the central counterparty that are mutual and hence eligible for netting . . .[23]

The same author, a scholar and special counsel to the English firm of Allen & Overy, has written elsewhere, "The problem of mutuality is solved by the ingenious device of inserting a company, the central counterparty, between the participants and the bankrupt X."[24] And his observation that "[t]he insertion of a central counterparty as principal is standard operating procedure in many organized securities, futures and options, and foreign exchange markets"[25] is demonstrably true.

Two significant examples include CLS Bank and the National Securities Clearing Corporation ("NSCC"), both of which take advantage of setoff rights as central contracting parties to minimize exposure as to the risk of any single participant's default.[26] CLS Bank operates the largest multi-currency cash settlement system to eliminate settlement risk in the foreign exchange market,[27] serving as counterparty to trades in total amounts many times more than world gross domestic product, but is able to reduce its risk exposure by roughly 95 percent by availing itself of the benefits of netting and setoff rights.[28] NSCC, a subsidiary of the Depository Trust and Clearing Corporation, "provides clearing, settlement, risk management, central counterparty services and a guarantee of completion for certain transactions for virtually all broker-to-broker trades involving equities, corporate and municipal debt, American depositary receipts, exchange-traded funds, and unit investment trusts" – literally billions of transactions with values of tens of trillions of dollars annually.[29] It is able to minimize risk of exposure to any bankruptcy by serving as the transaction counterparty for both sellers and buyers, transferring ownership onto its books during the exchange rather than merely serving as an administrator that facilitates clearing.[30] When an affiliate of NSCC, the Fixed Income Clearing Corporation ("FICC") announced plans to develop central counterparty capabilities

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[23] PHILIP R. WOOD, 2 THE LAW AND PRACTICE OF INTERNATIONAL FINANCE SERIES, VOL. 4: SET-OFF AND NETTING, DERIVATIVES, CLEARING SYSTEMS 97 - 98 (2007); *see also*, Wood, Philip R., "Legal Impact of the Financial Crisis: a Brief List", 4 *Capital Markets Law Journal* 4 (2009), at 443 (advocating for clearing of derivatives transactions through a central counterparty: "[t]he effect is that if the other trader becomes bankrupt, all trades between it and the central counterparty are mutual and can be netted off by the central counterparty so as to reduce exposures"); Geva, Benjamin, "The Clearing House Arrangement," 19 *Can. Bus. L.J.* (1991) at 143 ("Thus, the use of a central counterparty enables a multilateral netting scheme to maintain the requirement of mutuality between parties.").

[24] Wood, Philip, "What is a central counterparty in financial markets?", August 20, 2009, available at http://www.allenovery.com/AOWEB/AreasOfExpertise/Editorial.aspx?contentTypeID=1&itemID=52783&prefLangID=410

[25] WOOD, THE LAW AND PRACTICE OF INTERNATIONAL FINANCE, at 98.

[26] *Id.* at 99.

[27] "About CLS", available at http://www.cls-group.com/About/Pages/default.aspx

[28] WOOD, THE LAW AND PRACTICE OF INTERNATIONAL FINANCE, at 99.

[29] "About DTCC: "National Securities Clearing Corporation (NSCC)", available at http://www.dtcc.com/about/subs/nscc.php

[30] WOOD, THE LAW AND PRACTICE OF INTERNATIONAL FINANCE, at 99.

with respect to the mortgage-backed-securities market, it observed, "When we get the central counterparty fully operational, we expect to lower clearing costs, *reduce operational and counterparty risk*, decrease our customers' capital charges and bring down the fail and financing expenses of our clearing members."[31]

It should be emphasized that changing from a market where the operator is an agent, passing through all transactions to the market participants, who are the principals, to a market where the operator is the counterparty to all transactions as a principal is a change of substance, not just form. Each market participant is taking the credit risk of the central counterparty. The central counterparty is, concomitantly, taking the credit risk of each market participant. To be sure, there are devices, such as collateralization and setoff rights, that enable that credit risk to be managed. But both the market participants and the market operator/central counterparty have fundamentally changed their legal profiles.

B. Caselaw

While there are many cases addressing the applicability of setoff rights between conventional contracting parties,[32] we have not found a reported decision specifically involving a challenge to the setoff rights of a central counterparty. However, in an unreported decision that arose out of the *Enron Corp.* bankruptcy case in the United States Bankruptcy Court for the Southern District of New York, Case No. 01-B-16034, the bankruptcy court found there was mutuality between ERCOT and the debtor for purposes of setoff, despite the fact that ERCOT was *not* a central counterparty.[33]

In *Enron,* ERCOT brought a motion seeking relief from the automatic stay to exercise its rights of setoff against the debtor. Although the debtor did not dispute that there was mutuality with respect to its obligations to and from ERCOT, another participant did. The bankruptcy court ruled that the debts and obligations between the debtor and ERCOT were mutual for purposes of Bankruptcy Code Section 553 and granted ERCOT relief from the automatic stay in order to effect a setoff.[34] The bankruptcy court relied on ERCOT's then prevailing protocols,

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[31] "FICC Sets Timetable to Build Central Counterparty For Mortgage-Backed Securities Trading", available at http://www.dtcc.com/news/newsletters/dtcc/2006/apr/ficc.php.

[32] *See, e.g., In re Bevill, Bresler & Schulman Asset Management Corp.*, 896 F.2d 54, 57 (3d Cir. 1990); *re County of Orange*, 183 B.R. 609, 615 (Bankr. C.D. Cal. 1995); *Newbery Corp.* v. *Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1399 (9th Cir. 1996); *In re Westchester Structures, Inc.*, 181 B.R. 730, 739 (Bankr. S.D.N.Y. 1995).

[33] *In re Enron Corp., et al.*, Order Granting Motion By Electric Reliability Council Of Texas, Inc. For Relief From The Automatic Stay To Setoff Mutual Obligations, Case No. 01-B-16034 (AJG) (Bankr. S.D.N.Y. Dec 10, 2002).

[34] *Id.* at p. 7 ("[W]ith respect to the direct transfers of funds between [the debtor] and ERCOT in either direction, they each maintained the same capacities and the respective debts were mutual.").

which provided for settlement of a market participant's financial obligations in an individual market on a net basis.[35]

In *Enron,* ERCOT was not a central counterparty in the transactions at issue, yet the bankruptcy court found that that mutuality existed between ERCOT and the debtor for the purposes of setoff. The same aspects of the protocols that were conducive to the court finding mutuality in *Enron* will also be present in the new ERCOT regime and, in addition, ERCOT will become a central counterparty in transactions conducted on ERCOT markets. ERCOT becoming a central counterparty, and thus a principal in such transactions, will only increase the likelihood that a bankruptcy court will find that mutuality exists between ERCOT and a market participant for the purposes of setoff.

Additionally, we note that, while not uniformly favorable across jurisdictions, the caselaw is generally supportive of the setoff rights of creditors who acquire claims later sought to be used as setoffs through assignment or subrogation.[36] Hence, a counterfactual claim that ERCOT should not be entitled to setoff because a third party from which it received applicable rights and obligations (by hypothesis, another ERCOT member with a net position opposite that of the debtor against whom setoff is sought, the alleged "real" economic party in interest) should somehow be deemed to have retained ownership and responsibility for such rights and obligations should not be successful. Per above, we understand that ERCOT does not intend to take by assignment transaction obligations initially entered into on a bilateral basis by ERCOT members.

IV. Conclusion

We are of the view that ERCOT's new operating methods satisfy the conditions for setoff with respect to the transactions as to which ERCOT has been designated as central counterparty. As described above, a creditor may assert a right of setoff with respect to otherwise enforceable prepetition claims against a debtor if the claim and the prepetition debt against which it is sought to be set off are "mutual." Mutual means the debts to be set off are between the same parties, standing in the same right and in the same capacity. By establishing ERCOT as a formal contract party,

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[35] *Id.* at p. 5 ("Section 9.3 of the Protocols provides that Settlement Invoices are issued weekly and prepared on a net basis. The Invoice Recipient must pay the net debit and is entitled to receive a net credit regardless of any dispute concerning the amount.").

[36] *In re Assured Fastener Products Corp.*, 773 F.2d 105 (7th Cir. 1985) (subsidiaries who took claims against debtor by assignment from parent were entitled to set them off against obligations to debtor); *In re Photo Mech. Servs., Inc.*, 179 B.R. 604, 616 (Bankr. D. Minn. 1995) (creditor's claim acquired through equitable subrogation satisfies mutuality with debtor); *In re Metco Mining and Minerals, Inc.*, 171 B.R. 210, 216-17 (Bankr. W.D. Pa. 1994) (that creditor's claim is obtained through assignment does not defeat mutuality). It should be noted, however, that Bankruptcy Code § 553 does include some specific limitations on the use of claims to establish setoffs if such claims were acquired for the purpose of establishing a setoff in the 90 days prior to the debtor's bankruptcy.

taking title to assets delivered and incurring obligations in its own name, ERCOT should be able to satisfy this standard.[37]

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[37] It should be noted that the automatic stay of Bankruptcy Code section 362 applies to all rights of setoff, except those covered by Code sections 362(b)(6), (7) and (17). The extent to which sections 362(b)(6), (7) and (17) apply to receivables and payables related to transactions in the ERCOT markets is beyond the scope of this memorandum. However, to the extent that the automatic stay would apply to ERCOT's right of setoff, parties with setoff rights are generally able to obtain relief from the stay promptly.