BARNES & THORNBURG LLP

MEMORANDUM

TO: Midwest Independent Transmission System Operator, Inc.

DATE: April 25, 2013

SUBJECT: Setoff Under Amended Tariff

BACKGROUND

The Midwest Independent Transmission System Operator, Inc. ("**MISO**") recently amended its Open Access Transmission, Energy and Operating Reserve Markets Tariff[1] (as previously in force, the "**Prior Tariff**" and as amended, the "**Amended Tariff**"). The Amended Tariff explicitly provides that, with respect to energy market transactions, MISO is acting as the counterparty in the capacity of a principal and not as an agent as to those transactions. The Amended Tariff recognizes that MISO will not be a party to Generator Self-Supply[2] or Financial Schedule transactions except with regard to Transmission Usage Charges. The Amended Tariff explicitly provides that MISO is acting as agent for the Transmission Owners in collecting Transmission Charges.

SCOPE

This Memorandum considers whether MISO would have enforceable rights of setoff as against Market Participants for energy market transactions under the Amended Tariff.

SUMMARY

The Bankruptcy Code requires that claims be "mutual" in order to be set off. The Federal Energy Regulatory Commission ("**FERC**") and others have expressed concern that a failure to expressly characterize regional transmission operators and independent system operators as the counterparty to transactions in the wholesale electric markets might preclude their ability to set off amounts "due to" against amounts "due from" market participants because the mutuality requirement would not be met.[3] While there is no direct precedent, it is our opinion, based on the reasoned analysis below, that MISO's rights of setoff for energy market transactions as described below should be enforced in the bankruptcy case of a Market Participant.

PRIOR TARIFF PROVISIONS ON NETTING

Under MISO's Prior Tariff, there were express provisions for netting within each service category. In pertinent sections of the Prior Tariff, there is language that essentially results in a reduction of all debits and credits within a service category as between MISO and a Market

[1] Midwest Independent System Operator, Inc. Open Access Transmission, Energy and Operating Reserve Markets Tariff (effective 7/28/10) as amended by the amendments effective January 1, 2013.

[2] Capitalized terms used in this Memorandum are used as defined in the Prior Tariff or Amended Tariff.

[3] Notice of Proposed Rulemaking, Credit Reforms in Organized Wholesale Electric Markets (January 21, 2010), 75 Fed. Reg. 4310.

Atlanta Chicago Delaware Indiana Los Angeles Michigan Minneapolis Ohio Washington, D.C.

Participant to a net figure.[4] Also, the Prior Tariff provides for the setoff of all amounts due MISO by Market Participants against amounts due to the Market Participant.[5] Although the Amended Tariff does not alter and retains those provisions, we will not discuss the extent to which those provisions would provide an independent basis for netting amounts "due to" against amounts "due from" Market Participants.[6] Instead, this memorandum focuses on the new central counterparty provisions, and the potential impact that the limitations on setoff rights contained in Section 553 of the Bankruptcy Code may have on the new provisions.

AMENDED TARIFF WITH MISO AS CENTRAL COUNTERPARTY

As noted above, the Amended Tariff explicitly provides that MISO is the contracting counterparty to Market Participants with respect to energy market transactions and is acting as principal and not as agent for any other entity. The Amended Tariff is intended to establish MISO as a central counterparty in relation to all energy market transactions with a Market Participant. Accordingly, as is discussed in more detail below, these provisions of the Amended Tariff are also intended to put to rest any arguments along the lines advanced in the *Mirant* Chapter 11 case[7], where the "mutuality" of the claims between the California ISO and Mirant (as a market participant) had been put in doubt.

Under the Amended Tariff, MISO collects Transmission Charges in its capacity as agent for the Transmission Owners. Thus, in most transactions involving Market Participants, MISO is acting as principal for Market Transactions and as agent for Transmission Service. The MISO Credit Policy does not net amounts between Market Charges and Transmission Charges in calculating Total Potential Exposure, and therefore we will not discuss the extent to which set off between those two Charges would be permitted in the case of a bankrupt Market Participant.

Also, the Amended Tariff expressly establishes that MISO is not a party to Generator Self-Supply transactions (the "**Self-Supply Transactions**") except with regard to the Transmission Usage Charges (in particular the Cost of Congestion and Cost of Losses) where MISO is the contracting counterparty. This recognizes that the Energy injected at one location and extracted at another location by a Market Participant is not intended to be the purchase and sale of the Energy but, instead, the transmission of the Energy from one facility of the Market Participant to another facility of that Market Participant. The only energy charges associated with that transaction relate to constrained conditions or losses on the system and are collected by MISO as the contracting counterparty.

---

[4] For example, Section 7.6(a) of the Tariff provides that a Market Participant has "**no right** to any amount of payment … until all of the credit and debit amounts with respect to the Market Participant" for services and goods furnished under Module C and charges applicable to Load Modifying Resources pursuant to Module E or Module F have been netted." (emphasis added)

[5] Section 7.20 of the Tariff provides in part: "This Tariff … and all agreements entered into under, pursuant to, or in connection with this Tariff and any other agreements to which the Transmission Provider and the Tariff Customer are parties shall be viewed as a single agreement and the Transmission Provider shall have the right of setoff and recoupment with respect to all amounts that arise under this Tariff and/or any such agreements."

[6] *In re Charter*, 913 F.2d 1575 (11th Cir. 1990) held that language in a contract that provided for a net payment to a party, as is the case in the Amended Tariff, would be enforced and, under those circumstances, a setoff analysis was irrelevant. The Filed Rate Doctrine would also provide a rationale for permitting set off in accordance with the provisions of the Amended Tariff.

[7] *In re Mirant Core, et. al, Debtors*, Case No. 03-46590-DML-11 (N.D. Tex. December 9, 2005)

Finally, the Amended Tariff recognizes that MISO is not the central counterparty for Financial Schedule transactions (the "**Financial Schedule Transactions**") except for Transmission Usage Charges. Financial Schedules are a mechanism by which two Market Participants notify MISO of a private transaction between them for the sale of Energy. The Financial Schedule provided to MISO designates a Source Point, Sink Point and Delivery Point and establishes the obligations of the buyer and seller for the payment of Cost of Congestion and Cost of Losses (which are both Transmission Usage Charges). MISO is not the counterparty to the sale of Energy in a Financial Schedule Transaction since the counterparties to that sale are the two Market Participants who are the parties to the Financial Schedule. Like Self Supply Transactions, the only energy charges associated with Financial Schedule Transactions are the Transmission Usage Charges, which are collected from the Market Participant designated in the Financial Schedule by MISO as the contracting counterparty

BASIC REQUIREMENTS OF BANKRUPTCY CODE § 553

Section 553(a) of the United States Bankruptcy Code limits the ability of creditors to set off amounts due the debtor against amounts due to the creditor.[8] The bankruptcy law requires that claims be "mutual" in order to be eligible for set off or netting. For claims to be "mutual" they must be:

- between the same parties,
- owed in the same capacity, and
- in the same right.

If set off is not permitted, then the creditor will be required to pay the amount due the debtor in accordance with the terms of the transaction and participate with the other creditors in collecting from the debtor.[9]

The obligations must be owed by the same party. A must owe B and B must owe A in order for the debts to be set off against one another. A cannot set off an amount that it owes B against an amount B's subsidiary or affiliate owes A.

The obligations must be owed in the same capacity. In the simplest case, this means funds that a creditor owes to a debtor in the debtor's capacity as fiduciary cannot be offset against funds that the debtor owes to the creditor in an individual capacity, and vice versa. The general rule would suggest that the obligations must be owed and owing by the creditor and the

[8] As an initial matter, such netting may be within the scope of the automatic stay of 11 U.S.C. § 362(a). Paragraph (7) specifically includes a stay of "the setoff of any debt owing to the debtor that arose before the commencement of the case under [Title 11] against any claim against the debtor…" However, the automatic stay is a procedural device from which relief may be obtained upon various grounds, including "for cause" (see Section 362(d)). Ultimately and in brief, the automatic stay should not prevent the recognition and treatment of netting rights as discussed herein. *See*, *e.g.*, *In re Alexander Props., LLC*, 883 F.Supp.2d 552, 2012 U.S. Dist. LEXIS 110118, *8 (D.Ct. Md. 2012) (the U.S. Supreme Court's decision in *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 116 S. Ct. 286, 133 L. Ed. 2d 258 (1995) "makes clear that § 553 preserves the right of setoff with limited exceptions").

[9] Issues associated with specific exceptions to a creditor's rights of setoff that are contained in paragraphs (1)-(3) of Section 553(a), and the possibility of recovery under Section 553(b) of a setoff already exercised by a creditor prior to the commencement of a debtor's bankruptcy case, are outside the scope of and not addressed in this Memorandum.

debtor in their individual capacities or must be owed and owing by the creditor and the debtor in corresponding fiduciary capacities.

The final aspect of mutuality is that the obligations must be owed in the same right. The inquiry under this factor is whether the obligations to be set off are owed jointly with some other entity. This rule is intended to prevent prejudice to innocent third parties by prohibiting joint obligations to be set off against separate debts. Courts have allowed setoff involving joint debts only where doing so would not require satisfying one creditor's debt by extinguishing another creditor's debt.

THE *MIRANT* ARGUMENT

There has been concern that independent system operators such as MISO might not be able to set off amounts owing to them from market participants against amounts the ISO owes the market participant.[10] This concern arose from the assertion by a market participant, Mirant, in its Chapter 11 case that the amounts owed by Mirant to the California ISO and others could not be set off against amounts owed to Mirant as refunds due under a Federal Energy Regulatory Commission proceeding stemming from the California energy crisis of 2000-2001.[11] Mirant's position was based on a lack of "mutuality" of the claims running between and among the parties.[12] Mirant argued that mutuality did not exist because the California ISO was not a market participant, or a buyer or seller, for its own account.[13] Even though Mirant's argument was based on idiosyncratic facts, the transactions were not ordinary course set offs, and Mirant ultimately abandoned its position and settled,[14] some concern has remained that the mutuality requirement might preclude an ISO from net billing a market participant which has become a bankruptcy debtor for energy transactions.

The provisions in the Amended Tariff set out above which establish MISO as a central counterparty for energy transactions are intended to address the issue raised by FERC as to any potential lack of "mutuality" under Section 553(a) of the Bankruptcy Code that might prevent MISO from netting charges and credits for energy market transactions with Market Participants. Since energy generated or utilized by any particular entity cannot be specifically identified or traced from or to any other entity, a Market Participant as a debtor in a bankruptcy case may still attempt to make an argument similar to what had been asserted by Mirant in its Chapter 11 case involving the California ISO claims. The elements of such an argument could include:

- In "substance" the arrangements should be construed by the bankruptcy court as a "pooling" arrangement in which MISO has no actual or practical risk;

---

[10] The issue was raised by the FERC in a Notice of Proposed Rulemaking, Credit Reforms in Organized Wholesale Electric Markets (January 21, 2010), 75 Fed. Reg. 4310, 4313. FERC based its concern on a Memorandum of Wachtell, Lipton, Rosen & Katz to PJM regarding Setoff and Credit Risk of PJM in Member Bankruptcies (March 17, 2008)(the "**Wachtell Memorandum**").

[11] Joint Comments of the California Independent System Operator Corporation and Midwest Independent Transmission System Operator, Inc., Docket No. RM10-13-000, (March 15, 2010)("**Cal ISO Midwest ISO Comments**").

[12] Wachtell Memorandum, p. 10-11.

[13] Wachtell Memorandum, p. 10-11, quoting from Mirant's brief.

[14] Wachtell Memorandum, p. 11. Cal ISO Midwest ISO Comments, p. 2-3.

- The "form" of the underlying transactions as set forth in the Tariff (with MISO described as the universal counterparty) should therefore be disregarded;
- Mutuality of claims between two identifiable parties does not exist; and
- As a result the right of setoff under Section 553 of the Bankruptcy Code would be absent.

DISCUSSION

OVERVIEW

Unfortunately, we have found no published judicial decisions which directly focus upon a central counterparty situation such as the one in which MISO is placed under the Amended Tariff. However, based upon the explicit language that is included in the Amended Tariff as well as analyses undertaken and principles espoused by bankruptcy courts in somewhat analogous situations, we believe that, in a bankruptcy case of a Market Participant, it is likely that MISO would ultimately prevail in having its setoff rights for energy market transactions upheld as contemplated in the Amended Tariff.

RECENT CASES CONCLUDING THAT CERTAIN CLAIMS LACKED MUTUALITY

Within the past four years bankruptcy courts in leading jurisdictions have examined provisions in contracts that were designed to provide for the comprehensive setting off of claims between or among parties in situations where such a right would or might not otherwise (in the absence of such contractual provisions) have been permitted under Bankruptcy Code § 553 due to a lack of mutuality. As will be explained further below, the factual settings and transactions involved in these court decisions are distinguishable from the arrangements under the Amended Tariff where MISO is positioned as a central counterparty. Nevertheless, the reasoning of the opinions is instructive on how a court in a bankruptcy case of a Market Participant might be expected to analyze the provisions of the Amended Tariff.

Two recent opinions by bankruptcy courts in Delaware and the Southern District of New York have examined agreements that have been described as providing for "triangular" setoffs, where three or more parties were involved. These opinions illustrate difficulties with certain types of claims being recognized as "mutual" under Section 553 of the Bankruptcy Code, and consequently capable of being netted against each other.

In the Delaware case of *In re Semcrude, L.P.,* both the Bankruptcy Court and the District Court held that triangular setoff agreements are not enforceable in a bankruptcy setting. (hereinafter referred to as the *Semcrude-Chevron* decision).[15] In this case, Chevron entered into prepetition derivative transactions with three affiliated debtors, Semcrude, L.P., SemFuel, L.P., and SemStream, L.P. As credit enhancement, Chevron held the guaranty of SemGroup, L.P. for all its transactions with SemGroup's affiliates, and all the parties entered into agreements containing triangular setoff authorizations. Chevron had asked the bankruptcy court to permit it to set off its claims against two of the debtor-entities against its own indebtedness to another corporate debtor.[16] The Bankruptcy Court held that (1) requisite "mutuality" was lacking,

---

[15] *Chevron Prods. Co. v. Semcrude, L.P.* (*In re Semcrude, L.P.*), 428 B.R. 590 (D.Del. 2010).

[16] *In re Semcrude, L.P.*, 399 B.R. 388 (Bankr.D.Del. 2009).

notwithstanding a prepetition agreement between Chevron and the debtors purporting to permit Chevron to engage in such triangular setoffs; (2) "mutuality" could not be created by a private agreement between the parties; and (3) there was no contractual exception to the "mutuality" requirement.[17]

On appeal, the District Court affirmed the Bankruptcy Court, including its conclusion that the contracts at issue did not confer mutuality on Chevron.[18] The District Court stated that the Bankruptcy Court correctly recognized that the mutuality required by Section 553 "cannot be supplied by a multi-party agreement contemplating a triangular setoff," and indicated that this conclusion is not only consistent under the facts and applicable case law, but also with general bankruptcy principles concerning the strict construction of mutuality against the party seeking setoff.[19] Additionally, on appeal the Bankruptcy Court was upheld in its determination that a "contract exception" to the mutuality requirement does not exist in view of the plain language of Section 553, and the district court expressly noted that this determination was also consistent with the primary goal of the Bankruptcy Code to ensure equal and fair treatment among similarly situated creditors.[20]

Also, in an opinion issued 18 months ago in the *Lehman Brothers* case pending before the Bankruptcy Court in the Southern District of New York, UBS was denied its contractual right to a "triangular setoff" that was expressly recognized to be typically enforceable outside of a bankruptcy setting (hereinafter referred to as the *Lehman-UBS* decision).[21] In its opinion the Court cites to and essentially follows the reasoning of *Semcrude-Chevron,* and reiterated that a triangular setoff does not satisfy the Bankruptcy Code's mutuality requirement.[22] Specifically, the Court held that "[c]ontractual provisions that purport to create synthetic mutuality are not a substitute for the real thing. So-called triangular setoff that lacks mutuality, therefore, is not authorized under the Bankruptcy Code."[23] In sum, according to the Court, the parties' freedom to contract for triangular setoff rights "[wa]s neutralized by the plain language of Section 553."[24]

While scholars and legal experts have criticized the analyses in them,[25] the opinions in *Semcrude-Chevron* and *Lehman-UBS* are the only published cases which have recently and directly addressed the issues of mutuality in a triangular setoff situation. In essence, those decisions indicate that if mutuality within the purview of Bankruptcy Code § 553 did not initially

---

[17] *Id*.

[18] *In re Semcrude, L.P.*, 428 B.R. at 594.

[19] *Id.* (quoting *In re Semcrude, L.P.*, 399 B.R. at 397–98 (Bankr. D. Del.2009)).

[20] *Id.* (quoting *In re Semcrude, L.P.*, 399 B.R. at 397–98 (Bankr. D. Del.2009)).

[21] *In re Lehman Bros. Inc.*, 458 B.R. 134 (Bankr. S.D.N.Y. 2011) .

[22] *Id.,* at 136, 142 ("[A] contractual right of setoff that permits netting by multiple affiliated members of the same corporate family outside of bankruptcy may no longer be enforced after the commencement of a case governed by provisions of [the Bankruptcy Code]").

[23] *Id.* at 136–37.

[24] *Id.* 458 B.R. at 140–41.

[25] *See, e.g.*, M. Bienenstock et al., *Are Triangular Setoff Agreements Enforceable in Bankruptcy?* 83 AM. BANKR. L.J. 325 (Spring 2009).

exist in the underlying transactions, then contractual provisions that purport nevertheless to provide for the netting of claims will not be given effect in a bankruptcy case.

Another aspect of the mutuality requirement of Section 553 has recently been examined in the *Lehman Brothers* case, both by the Bankruptcy Court and in an appeal to the District Court for the Southern District of New York (hereinafter referred to as the *Lehman-Swedbank* decision).[26] Rather than a "triangular" setoff situation with three or more parties, this situation involved only two parties (one of which was a debtor in a bankruptcy case) holding claims against each other. Again, the question was whether the provisions in a contract providing for comprehensive netting of claims were enforceable in bankruptcy even though the claims lacked mutuality in the first instance. The non-debtor Swedbank conceded that the claims between it and the debtor LBHI were not "mutual," because the claim by Swedbank against LBHI arose prior to the commencement of the bankruptcy case, and the particular claim at issue by LBHI against Swedbank was based upon a deposit made with Swedbank after commencement of the bankruptcy case. Nevertheless, Swedbank argued that it had a right to set off these claims pursuant to a master agreement related to swap arrangements between the parties, and that "the mutuality requirement of [S]ection 553 [wa]s rendered inapplicable by the safe harbor provisions of [S]ections 560 and 561 of the Bankruptcy Code" (which refer to and are designed to protect various "contractual" rights).[27]

In dismissing Swedbank's argument, the Bankruptcy Court determined that the safe harbor provisions "do not alter the axiomatic principle of bankruptcy law, codified in [S]ection 553, requiring mutuality in order to exercise a right of setoff," and emphasized that such setoff right "must exist in the first place" in order to be recognized or permitted under the safe harbor provisions.[28] On appeal, the District Court upheld the Bankruptcy Court's conclusions, and noted that there was a "paucity of support" for Swedbank's position that "the Safe Harbor Provisions permit parties to contract out of the requirements of the Bankruptcy Code."[29]

The outcome in *Lehman-Swedbank* may be narrowly construed because the safe harbor provisions of the Bankruptcy Code were of primary focus and the opposing claims arose in disparate time periods.[30] Nevertheless, at a fundamental level the decisions of both the Bankruptcy Court and the District Court reinforce the point that if there is no underlying mutuality of claims between two parties, an override of that lack of mutuality and a set off of those claims pursuant to a contract between the parties will not be permitted in the bankruptcy case of one of those parties.[31]

---

[26] *In re Lehman Bros. Holdings, Inc.*, 433 B.R. 101, 108 (Bankr. S.D.N.Y. 2010).

[27] *Id.* at 109.

[28] *Id.*

[29] *Swedbank AB v. Lehman Bros. Holdings, Inc. (In re Lehman Bros. Holdings, Inc.)*, 445 B.R. 130, 137 n.6 (Bankr. S.D.N.Y. 2011).

[30] As noted above, one claim arose prior to the commencement of the bankruptcy case, while the other claim arose after the petition date. Accordingly, this is one classic example of the types of claims which do not have mutuality for the purposes of Section 553.

[31] As more specifically discussed herein, the *SemCrude-Chevron* case involved other aspects of the mutuality requirement under Section 553(a) – in particular, the issue of whether claims running between Chevron and multiple other parties may be treated in accordance with the provisions of a netting agreement, and thereby "triangular" setoffs could be accomplished.

ELEMENTS OF CLAIM MUTUALITY FOR MISO AS UNIVERSAL COUNTERPARTY

Clearly, the cases described above reflect a judicial tendency toward strict interpretation of mutuality concepts associated with rights of setoff under Bankruptcy Code § 553. However, unlike in the *Semcrude-Chevron* and *Lehman-UBS* cases where non-matching claims among three or more parties were involved, each instance of setoff with MISO as central counterparty for energy transactions would expressly (in accordance with the provisions of the Amended Tariff) include claims only between MISO and one specific Market Participant.

The requisite elements of mutuality under Section 553 should be satisfied in the anticipated situation where MISO under the Amended Tariff will be in the capacity of the universal counterparty for energy market transactions. The key underlying concepts of mutuality – that there be opposing claims between the same two parties and in the same right – appear to be established and addressed in the language of the Amended Tariff. These concepts (summarized in a prior section) are more specifically described in the case of *In re Britton*:[32]

> As a general rule, the right to set-off exists only if each party owns his own claim in his own right severally with the right to collect it in his own name against the debtor in his own right and severally…. As a result of this rule, a joint debt may not be set off against a separate debt or vice versa; and debts accruing in different rights are not allowed to be set-off against each other due to lack of mutuality….[33]

Despite these requirements, the principles of mutuality under Section 553 are considerably less restrictive than the elements that are necessary to effect a recoupment.[34] As noted in a leading treatise on bankruptcy law, "[i]n general, the character of an obligation is irrelevant for purposes of mutuality under Section 553…. Thus, a contract claim may be offset against a tort claim, and a statutory claim may be offset against an obligation arising in equity."[35] In summary, even though claims between two parties may not have arisen from or be based upon the same transaction, contract, occurrence or situation, it is still often possible for those claims to be considered "mutual" and therefore capable of affirmative treatment under Section 553 (so long as the earlier-described "same right" and "same capacity" elements are also satisfied).[36]

These accommodative aspects of Section 553 are illustrated in the case of *In re Coast Grain Co.*[37] The debtor Coast Grain, a livestock feed retailer, developed a pre-payment program allowing customers to deposit cash with Coast Grain and receive discounts on subsequent orders. As part of this arrangement, Coast Grain also agreed to make payments from the pre-payment account of a customer to third parties, without restriction, upon instruction from the customer.

---

[32] 83 B.R. 914, 918 (Bankr. E.D.N.C. 1988).

[33] Citations to cases and specific references in the treatise *COLLIER ON BANKRUPTCY* have been omitted.

[34] See 5 *COLLIER ON BANKRUPTCY* ¶ 553.10[3] (2013) ("[i]n general, courts have concluded that the doctrine of recoupment should be narrowly construed in bankruptcy cases").

[35] 5 *COLLIER ON BANKRUPTCY* ¶ 553.03[3][e] (2013).

[36] *Id.* ¶ 553.03[3][a] (2012); *see, e.g.*, *Braniff Airways v. Exxon Co.*, 814 F.2d 1030, 1035 (5th Cir. 1987); *Burton v. United States* (*In re Selma Apparel Corp.*), 155 B.R. 241, 243 (Bankr. S.D. Ala. 1992).

[37] No. EC-05-1187-PaNMa, 2006 Bankr. LEXIS 4792, 2006 WL 6810917 (B.A.P. 9th Cir. Jan. 31, 2006).

The Bankruptcy Appellate Panel for the Ninth Circuit upheld the Bankruptcy Court's decision that the conditions required by Section 553 for mutuality and setoff were met. Specifically, the Panel upheld the Bankruptcy Court's finding that

> Coast Grain's sales of dairy feed to Bouma, and the third-party payments made for Bouma's benefit, generated contract rights against Bouma of equal value. Bouma's liability for those contracts and Coast Grain's liability on the prepaid account were *mutual* obligations subject to potential setoff. The actual "transfer of property of the debtor" occurred each time Coast Grain gave up the right to collect its accounts receivable, when Coast Grain debited its claim against Bouma's prepaid account.[38]

The Panel concluded that mutuality was established when Coast Grain advanced funds or product to Bouma, and Bouma deposited cash with Coast Grain. Details of individual sales, payments to third parties, or deposits were not necessary to establish mutuality because Coast Grain's payments to third parties were treated as payments made on Bouma's behalf, creating a separate and distinct debt owed by Bouma to Coast Grain.

In its role as an intermediary between particular customers and third parties specifically identifiable to those customers, Coast Grain did not stand in the chain of title to goods purchased by Bouma from third parties. Despite the difficulties presented by these facts, the Ninth Circuit found that mutuality had been established. The nature of MISO's relationship with the Market Participants under the Amended Tariff, where MISO is expressly established as a universal counterparty for energy transactions, presents an even more compelling case for setoff enforceability.

Also, the 2005 decision in the case of *In re Bangor & Aroostook Railroad Co*.[39] supports a conclusion that the terms of the Amended Tariff are a proper basis for netting claims in accordance with Section 553. In that case, there were numerous and recurring interline freight charges among many railroads, and a "comprehensive arrangement to 'net out' their entitlements and obligations on a monthly basis."[40] Although complicated and involving numerous transactions, the court recognized that "[t]he circumstances [could be] reduce[ed] to sets of bilateral relationships in which one railroad owes freight charges to another, and the second owes freight charges back to the first."[41] Therefore, the court concluded that "the debts, if debts they be, [we]re mutual."[42] Just as the respective companies associated with each freight charge could

---

[38] *Id.*, 2006 Bankr. LEXIS at *9–*10 (citing *In re Coast Grain Co.*, 317 B.R. 796, 805 (Bankr. E.D. Cal. 2004) (emphasis added)).

[39] *Howard v. Burlington Northern & Santa Fe Ry. (In re Bangor & Aroostook R.R. Co.)*, 320 B.R. 226, 228 (Bankr. D. Me. 2005), *aff'd.* 2007 U.S. Dist. LEXIS 13125 (D.Ct. Me. 2007).

[40] 320 B.R. at 228.

[41] *Id.* at 231.

[42] *Id.* Both the Bankruptcy Court and the District Court (which on appeal summarily affirmed the Bankruptcy Court) noted that there was a divergence in opinions among certain of the U.S. Circuit Courts of Appeal on whether funds received for interline freight charges could be determined to be be held in trust under non-bankruptcy law. The defendant railroads in the avoidance and recovery action brought by the bankruptcy trustee before the Bankruptcy Court argued that such a trust existed, since a rule of the clearinghouse serving the railroads provided that "a collecting carrier acts as a trustee, and holds monies collected in trust for the other carriers in the route." 320 B.R. at 229. The bankruptcy court noted that "without [the rule's] gloss, the relations [between the railroads] is a classic

be identified and their claims netted or reconciled in the *Bangor & Aroostook Railroad* situation,[43] such should also be the case with MISO acting in its capacity as counterparty.

Pursuant to the Amended Tariff, there would be specific, identifiable amounts owed between MISO and a Market Participant in any particular service category. Under the principles recognized in both the *Coast Grain* and the *Bangor & Aroostook Railroad* cases, there does not appear to be any definite reason for a bankruptcy court to deny MISO the ability to exercise setoff rights as contemplated by Section 553.

LIMITATIONS ON AUTHORITY OF A BANKRUPTCY COURT

OVERVIEW

This section outlines additional arguments that may be supportive of MISO's rights to net or set off claims as a universal counterparty under the Amended Tariff. While the court opinions cited below involve distinguishable facts, certain underlying concepts discussed in the opinions could be applicable in MISO's situation, and accordingly limit a bankruptcy court's authority to restructure or otherwise denigrate the efficacy of the central counterparty provisions of the Amended Tariff.

INAPPLICABILITY OF EQUITABLE AND REFORMATION DOCTRINES

On their face, the netting provisions in the Amended Tariff — with MISO as the universal counterparty for energy market transactions — should satisfy the mutuality requirements under Bankruptcy Code § 553. A dispute about MISO's ability to set off claims in a Market Participant's bankruptcy case would essentially be based upon an assertion that, notwithstanding the express language in the Amended Tariff, MISO should not be viewed as acting as a principal in its dealings with Market Participants but rather as an agent or fiduciary of the other Market Participants.

Accordingly, it would seem that in its bankruptcy case the Market Participant would initially or fundamentally be attempting to invoke the equitable powers of the bankruptcy court to "reform" the terms and provisions of the Amended Tariff, and defeat MISO's setoff rights. A bankruptcy court in presiding over a case has equitable powers, and Section 105(a) of the Bankruptcy Code states that the court "may issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title."[44] However, the bankruptcy court's equitable powers are limited.

Section 105(a) does not authorize a bankruptcy court to create substantive rights "that are otherwise unavailable under applicable law," and the provision does not grant a bankruptcy court a "roving commission to do equity."[45] In fact, the Seventh Circuit has declared that it

case of mutual debts." 320 B.R. at 231. Unlike the rule at issue in the *Bangor & Aroostook Railroad* case, the Amended Tariff and other contractual arrangements between MISO and the Market Participants do not describe or endeavor expressly to establish a trust with respect to sums owed or collected in their various transactions.

[43] The Bankruptcy Court then addressed preliminarily whether the netting of claims which occurred among the companies within 90 days prior to the inception of the bankruptcy case could be subjected to avoidance and recovery by the bankruptcy trustee under Bankruptcy Code § 553(b), a question that is beyond the scope of this Memorandum. *See supra* note 8.

[44] 11 U.S.C. § 105(a).

[45] *See New England Dairies Inc. v. Dairy Mart Convenience Stores Inc. (In re Dairy Mart Convenience Stores, Inc.)*, 351 F.3d 86, 92 (2d Cir. 2003) (quoting *United States v. Sutton*, 786 F.2d 1305, 1308 (5th Cir. 1986)).

"deprecate[s] flaccid invocations of 'equity' in bankruptcy proceedings. Creditors have rights . . . and bankruptcy judges are not empowered to dissolve rights in the name of equity."[46] Stated slightly differently, the equitable power conferred on the bankruptcy court by Section 105(a) is the power to exercise equity in carrying out the provisions of the Code, rather than to further the purposes of the Code generally or "otherwise to do the right thing."[47] In light of this limitation, a bankruptcy court may be called upon to exercise its equitable powers, but could find itself powerless to act if the requested remedy cannot be tied to a specific provision of the Code.[48]

Given the provisions in the Amended Tariff, MISO could take the position that a Market Participant in a bankruptcy case might be able to override those provisions only if, as a matter of nonbankruptcy law, there is a compelling basis for reform of the express arrangements. For example, in considering a debtor's request for reformation and citing to Delaware state law which is also typical of other jurisdictions on this topic, a bankruptcy court has observed:[49]

> Under Delaware law, reformation of a contract is appropriate only when "the contract does not represent the parties' intent because of fraud, mutual mistake, or in exceptional cases, a unilateral mistake coupled with the other parties' knowing silence." *Chase Manhattan Bank v. Iridium Africa Corp.,* 197 F. Supp. 2d 120, 139 (D. Del. 2002); *Emmert v. Prade,* 711 A.2d 1217, 1219 (Del. Ch. 1997) (both *quoting James River–Pennington Inc. v. CRSS Capital, Inc.,* C .A. No. 13870, 1995 WL 106554 (Del. Ch. March 6, 1995)). Here GALC has never alleged that the Stipulation reflects anything but the intent of the parties. Rather GALC argued at the hearing that I may reform a contract based upon the Bankruptcy Court's broad equitable powers. Not surprisingly, GALC fails to provide any authority that my powers cut such a broad swath. In any event, as there was no evidence presented in connection with the Modification Motion or the Stipulation, I would not have the slightest notion about the equities in this matter.

Also, the existence or inclusion of the netting provisions within a regulatory environment should provide more weight against any attempted reformation of the tariff provisions. The Seventh Circuit (Judge Posner writing the opinion of the Court) stated the following in *Western Transportation Co. v. Wilson and Co., Inc.:*[50]

> But Congress did not create a flexible standard for the courts to apply in accordance with the facts, equities, and economic realities of the particular case. It forbade carriers to receive any different compensation from the rate in the applicable tariff.... **There is no judicial power of equitable reformation of tariffs as ordinary contracts**. (Emphasis added.)

[46] *In re Lapiana*, 909 F.2d 221, 224 (7th Cir. 1990).

[47] *Id.*; *see* Michael D. Sousa, *Equitable Powers of a Bankruptcy Court: Federal All Writs Act and § 105 of the Code: Part I*, AMERICAN BANKRUPTCY INSTITUTE (June 1, 2006).

[48] *Id.*

[49] *In re Wilmington Hospitality LLC*, No. 01-19401DWS, 2003 Bankr. LEXIS 404, at *15–*16, 2003 WL 21011689, at *4 (Bankr. E.D. Pa. 2003).

[50] 682 F.2d 1227, 1231 (7th Cir. 1982).

There are numerous decisions which have followed this reasoning, including by the U.S. Supreme Court in the case of *Square D Co. v. Niagara Frontier Tariff Bureau, Inc.*[51]

PREEMPTION BY OR DEFERENCE TO FERC REGULATION AND TARIFF PROVISIONS

Bankruptcy Courts have generally noted and accommodated the broad and exclusive authority of FERC to regulate "the transmission and sale at wholesale of electric energy in interstate commerce."[52] This authority extends beyond FERC's ability to set rates, and includes various business activities of the regulated parties. For example, in the case of *In re Enron Corp.,*[53] the Bankruptcy Court quoted from the Federal Power Act[54] and emphasized the ability of FERC to "***determine*** the just and reasonable rate, charge, classification, rule, regulation, ***practice***, or contract to be thereafter observed and in force, and shall fix the same by order." (Emphasis in original.)

Also, in bankruptcy situations it has been recognized that "[f]ederal tariffs have the force of federal law and are not simply contractual."[55] Along these lines, MISO might pursue a related argument that the provisions of the Amended Tariff fall within the purview of the Filed Rate Doctrine as well. Under this doctrine, a bankruptcy court may be precluded from interfering with, or at least should give considerable deference to, the outcomes fostered by provisions in a FERC-approved tariff. Since FERC has exclusive jurisdiction over the reasonableness of rates for wholesale electricity in interstate commerce, it can be asserted that the counterparty provisions contained in the Amended Tariff (based upon the characterization of MISO as a principal in energy market transactions) are inextricably intertwined with "filed rates" which are within the scope of or subject to the Filed Rate Doctrine.[56] Therefore, in the bankruptcy case of a Market Participant, MISO could take the position that the court would be required to give effect

---

[51] 476 U.S. 409, 106 S. Ct. 1922, 90 L. Ed. 2d 413 (1986) (holding superseded by statute in certain respects other than the general efficacy of a tariff); *see also Regular Common Carrier Conference v. United States*, 793 F.2d 376 (D.C. Cir. 1986); *Aero Trucking, Inc. v. Regal Tube Co.*, 594 F.2d 619 (7th Cir. 1979); *Illinois Cent. Gulf R.R. Co. v. Golden Triangle Wholesale Gas Co.*, 586 F.2d 588 (5th Cir. 1978).

[52] *In re NRG Energy, Inc.*, No. 03-13024, 2006 Bankr. LEXIS 1963, at *11, 2006 WL 2385217, at *2 (Bankr. S.D.N.Y. May 17, 2006) (internal quotation marks omitted) (citing *New England Power Co. v. New Hampshire*, 455 U.S. 331 (1982)).

[53] No. 01 B 16034, 2005 Bankr. LEXIS 3472, 2005 WL 3873894 (Bankr. S.D.N.Y. July 22, 2005).

[54] 16 U.S.C. § 824(e).

[55] *Enron Power Mktg. v. Cal. Power Exch. Corp. (In re Enron Corp.)*, No. 04 Civ 8177, 2004 U.S. Dist. LEXIS 23868, at *9, 2004 WL 2711101, at *3 (S.D.N.Y. Nov. 23, 2004) (internal quotation marks omitted) (citing *AT&T v. City of New York,* 83 F.3d 549, 552 (2d Cir. 1996))*; see also In re Birch Telecom, Inc.,* No. 05-12237, 2009 Bankr. LEXIS 1282, at *5–*6, 2009 WL 1531792, at *2 (Bankr. D. Del. June 2, 2009) (citing several cases that support the proposition that a filed tariff is equivalent to law).

[56] *See Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U.S. 354, 375 (1988) (filed rates include non-price terms and conditions); *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 966 (1986) ("the filed rate doctrine is not limited to 'rates' *per se*: 'our inquiry is not at an end because the orders do not deal in terms of prices or volumes of purchases'") (citations omitted); *California Dep't of Water Res. v. Calpine Corp. (In re Calpine Corp.)*, 337 B.R. 27, 32 (S.D.N.Y. 2006) ("FERC's jurisdiction and the filed rate doctrine stretches past regulation of rates . . . and extends to the terms and conditions of wholesale energy contracts").

to the Amended Tariff terms, and thus allow MISO to utilize setoff in determining amounts due to and from Market Participants. [57]

Several of the above-described principles that would lead to upholding the provisions of the Amended Tariff in the bankruptcy case of a Market Participant were reviewed and applied in a decision of the Third Circuit Court of Appeals in the Chapter 11 case of *Columbia Gas Systems*.[58] The case involved a pipeline company that "purchas[ed] natural gas from upstream pipeline suppliers, transport[ed] this gas in interstate commerce, and res[old] it to local distribution companies."[59] There was no universal counterparty involved in the transactions among Columbia, its suppliers and its customers, and the factual setting is distinguishable from that addressed by the Amended Tariff. Nevertheless, the case illustrates how a regulatory regime (authorized by federal statute and implemented by FERC) can control over rights or claims that may possibly have otherwise existed (under contract theories or by other state law).

The central issue in the *Columbia Gas* decision was whether certain refund payments which Columbia expected to receive (as well as refund payments it had already obtained) from its upstream suppliers, and which in turn were to be paid or passed on to its customers, constituted property of Columbia's bankruptcy estate. The Appellate Court concluded that federal common law (rather than state law) should be applied in defining what rights Columbia had in the refund payments. Next, it held that the refund payments did not constitute property of Columbia's bankruptcy estate because Columbia was a "conduit" for the refund payments and therefore Columbia "ha[d] no equitable interest" in them. These determinations were driven by the recognition that "the refunds and the mechanism to distribute them were created by FERC [in orders and a modified tariff for Columbia], pursuant to its statutory authority under the [Natural Gas Act]."[60]

Similarly, the provisions of the Amended Tariff have become effective under a regulatory regime established under the Federal Power Act and specifically under an order from FERC. By their express terms as well as under applicable law, the tariff provisions should control over any possible rights, claims, accountings or other items that might be inconsistent therewith.

TREATMENT OF FINANCIAL SCHEDULE TRANSACTIONS AND SELF-SUPPLY TRANSACTIONS

The treatment of Financial Schedule Transactions should be straightforward in the event of a Market Participant bankruptcy. Financial Schedule Transactions are primarily settled outside the MISO market by and between the Market Participants that are the counterparties to the transaction. MISO is not involved in the collection or distribution of revenue with respect to Financial Schedule Transactions, except with respect to the Transmission Usage Charges aspect

[57] There is a dearth of case law specifically taking into account both Bankruptcy Code § 553(a) and the provisions in a FERC-approved tariff. However, federal courts considering the interplay between other portions of the Bankruptcy Code and the Federal Power Act have tended to uphold FERC's exclusive jurisdiction. Specifically, federal courts have held that FERC "need not defend its regulatory calculus in the bankruptcy court . . . [I]f the decision is regulatory, it may not be altered or impeded by any court lacking jurisdiction to review it." *NRG Power Mktg., Inc. v. Blumenthal (In re NRG Energy)*, No. 03 Civ 3754, 2003 U.S. Dist. LEXIS 11111, at *10, 2003 WL 21507685, at *3 (S.D.N.Y. June 30, 2003).

[58] *In re Columbia Gas Systems Inc.*, 997 F.2d 1039, 1051 (3d Cir. 1993).

[59] *Id*.

[60] *Id*. at 1060–62.

of a Financial Schedule Transaction. The Amended Tariff recognizes the fact that MISO is not a party to Financial Schedule Transactions, except with respect to Transmission Usage Charges, which it collects in its central counterparty capacity. Because MISO is not actually involved in the collection or distribution of revenue for Financial Schedule Transactions, MISO will not need the right to set off amounts relating to Financial Schedule Transactions. The Transmission Usage Charges associated with the Financial Schedule Transactions should be treated like any other Market Charges. MISO should have setoff rights against the Market Participant (who is designated by the Financial Schedule as owing the Transmission Usage Charges), as the contracting counterparty, to the extent detailed elsewhere in this Memorandum.

Self-Supply Transactions, while not as straightforward as Financial Schedule Transactions, should also be able to benefit from setoff rights. As we understand it, MISO does not contemplate adjusting its accounting and settlement systems to back out the energy charges for Self-Supply Transactions from the settlement statements that MISO provides to Market Participants. Thus, the settlement statements will show energy charges and credits for Self-Supply Transactions. It is conceivable that a Market Participant which is a debtor in a bankruptcy case could argue that the settlement statement is evidence of a purchase and a sale of energy involving MISO and the Market Participant and, given the statement in the Amended Tariff that MISO is not a counterparty to any sale of energy in a Self-Supply Transaction, that a *Mirant*-like argument can be made that mutuality is not present and set off is not available.

The Amended Tariff clearly states that charges which appear on a Market Participant's settlement statements are only an accounting convenience and do not make MISO a party to the sale or purchase of energy[61]. Accordingly, the Market Participant would face an initial hurdle in attempting to persuade a bankruptcy court that it should disregard that language in the Tariff. That hurdle will most likely be insurmountable, since the principles set out in preceding sections that justify the viability of the provisions establishing MISO as a central counterparty in energy transactions also equally support the enforceability of the provisions in the Amended Tariff positioning MISO as a conduit for the Self-Supply Transactions.

Though accounting or other settlement statements might appear to be to the contrary, the Amended Tariff expressly states that the provisions of the Tariff shall control. As specifically noted in the *Columbia Gas* case, since the refund payments at issue had been established or mandated by FERC regulation, "[n]either Columbia nor its customers could alter their respective interests in the refunds by contract."[62] As a debtor in a bankruptcy case, a Market Participant might, at best, be able to advance an argument that the accounting and settlement systems evidenced or indicated some form of contract-based arrangements or rights. However, in accordance with the various authorities cited above, any such possible contractual interests should be subordinate to and overridden by the express provisions of the Amended Tariff.

---

[61] See Section 6A of Amended Tariff.

[62] *Id*. at 1060; *see also AT&T v. Cent. Office Tel., Inc.*, 524 U.S. 214, 227 (1997) ("[t]he rights as defined by the tariff [which was subject to regulation by the Federal Communications Commission] cannot be varied or enlarged by either contract or tort of the carrier")(holding superseded by statute in certain respects other than the general efficacy of a tariff); *Cal. ex rel Lockyer v. Mirant Corp.*, 266 F. Supp. 2d 1046, 1061 (N.D. Cal. 2003) (applying the Supremacy Clause to a tariff approved by FERC, and indicating that such tariff provisions are supreme and preemptive of state law).

CONCLUSION[63]

Based upon the reasoned analysis in this Memorandum, it is our opinion that MISO's rights of setoff for energy market transactions as described above should be enforced in the bankruptcy case of a Market Participant.

Barnes & Thornburg LLP

SJD:DMP:JPH

[63] We understand that a copy of this Memorandum will be shown to the Commodity Futures Trading Commission ("**CFTC**") for information purposes only and a copy will be posted on the CFTC's website in connection with MISO's exemption petition. No person or entity other than MISO is authorized to rely upon this Memorandum without express written consent from Barnes & Thornburg LLP.