WILMERHALE

MEMORANDUM

Date February 14, 2012

To ISO New England

From John D. Sigel
Paul M. Architzel
Michelle A. Goldis

Re **Setoffs of ISO New England in Market Participant Bankruptcies**

Introduction

ISO New England (the "ISO") is a Delaware corporation, recognized by the Federal Energy Regulatory Commission (the "Commission") as an independent system operator in 1997 and as a regional transmission organization in 2005. The ISO is responsible for ensuring the day-to-day reliable operation of New England's bulk power generation and transmission system, overseeing and ensuring the fair administration of the region's wholesale electricity markets and managing comprehensive, regional planning processes.

The ISO has asked us to assess whether the designation of the ISO as a central counterparty ("CCP") for certain transactions in the ISO's markets satisfies the mutuality condition necessary to assert setoff rights in the event of a bankruptcy of an ISO market participant. Part I of this memorandum addresses the conditions that must be met for the recognition of enforceable setoff rights generally. Part II addresses the application of the law of setoff to the ISO in light of its current and future structure and the structure of the energy markets which it administers. Part III contains the conclusion that we know of no precedent holding that the proposed CCP structure for certain electricity transactions would not give rise to enforceable rights of setoff of the CCP against its counterparties under Title 11 of the United States Code (the "Bankruptcy Code") in the event of the bankruptcy of any of its counterparties.

I. Setoff Rights Under the Bankruptcy Code

A. Protection of Setoff Rights

Section 553 of the Bankruptcy Code governs setoff following the commencement of a bankruptcy case, and except as limited by the automatic stay of section 362, preserves the non-bankruptcy right of a "creditor to offset a mutual debt owing by such creditor to the debtor that

arose before the commencement of the case."[1] Section 553 does not itself create any rights of setoff, but recognizes and preserves rights of setoff where four conditions exist:

1. The creditor holds a "claim" against the debtor that arose before the commencement of the bankruptcy case;

2. The creditor owes a "debt" to the debtor that also arose before the commencement of the bankruptcy case;

3. The claim and the debt are "mutual"; and

4. The claim and the debt are each valid and enforceable.[2]

As the Supreme Court has explained, the right of setoff serves a commonsense purpose: it "allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'"[3] Setoff under section 553(a) "does not eviscerate the debt of either the creditor or the debtor but allows the court to net the pre-petition mutual debts between the two parties."[4]

Setoff, in effect, elevates the holder of an unsecured claim to the preferred status of a secured creditor, to the extent that the debtor has a mutual, prepetition claim against the creditor.[5] Such an elevation in status is to the detriment of other unsecured creditors, and the decision to grant stay relief to permit a party to exercise the right of setoff is within the sound discretion of the bankruptcy court.[6] "Equity favors the right of setoff as a means to avoid multiplicity of lawsuits, inconvenience, injustice, and inefficient use of judicial resources."[7] Accordingly, setoff ordinarily should be "enforced unless the court finds after due reflection that allowance would not be consistent with the provisions and purposes of the Bankruptcy [Code] as a whole."[8]

---

[1] 11 U.S.C. §553(a).
[2] 11 U.S.C. §553(a); *see also Pub. Serv. Co. v. N.H. Elec. Coop., Inc. (In re Pub. Serv. Co.)*, 884 F.2d 11, 14 (1st Cir. 1989); *In re Garden Ridge Corp.*, 338 B.R. 627, 633 (Bankr. D. Del. 2006), *aff'd*, 399 B.R. 135 (D. Del. 2008).
[3] *Citizens Bank v. Strumpf*, 516 U.S. 16, 18 (1995), quoting *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528 (1913).
[4] *Gulfcoast Workstation Corp. & Relational Funding Corp. v. Peltz (In re Bridge Info. Sys.)*, 314 B.R. 421, 432 (Bankr. E.D. Mo. 2004).
[5] *See* 11 U.S.C. § 506(a).
[6] *See Bank of Am., N.A. v. Lehman Bros. Holdings Inc. (In re Lehman Bros. Holdings Inc.)*, 439 B.R. 811 (Bankr. S.D.N.Y. 2010).
[7] *Id.* at 824.
[8] *Pereira v. United Jersey Bank, N.A.*, 201 B.R. 644, 679 (S.D.N.Y. 1996), citing *Bohack Corp. v. Borden, Inc. (In re Bohack Corp.)*, 599 F.2d 1160, 1165 (2d Cir. 1979) (referencing section 68 of the Bankruptcy Act of 1898, the predecessor to section 553 of the Bankruptcy Code).

B. The Mutuality Requirement

As noted above, a key requirement for setoff is that the relevant claim and debt be "mutual." Section 553 does not define "mutual," but it has generally been interpreted to mandate that the debt owed by the debtor to the creditor and the claim of the debtor against the creditor must have "arisen in the same right" between the same parties acting in the same capacities.[9]

Same Right. The obligations must be owed in the same right. The intent of the rule is to prevent prejudice to innocent third parties by prohibiting joint obligations to be set off against separate debts. "The distinguishing feature of the [same right] concept is that it subsumes the separate question of whether any of the obligations sought to be offset are owed jointly with some other entity."[10] "As a general rule, a joint debt cannot be set off against a separate debt, or conversely, a separate debt against a joint debt."[11]

Same Parties. The claim and the debt must be between the same parties—party A must owe party B and party B must owe party A. Party A cannot set off an amount that it owes to party B against an amount party B's subsidiary or affiliate owes party A. Additionally, triangular setoffs are not protected by the Bankruptcy Code—A may not offset an obligation that it owes to B against a debt that B owes to C.[12] In short, the identity of the parties to the claim and the debt must be identical.

Same Capacity. The claim and the debt must be owed in the same capacity. For example, funds that a creditor owes to the 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*. To satisfy the capacity requirement, obligations must be owed and owing by the creditor and the debtor in their individual capacities, or must be owed and owing by the creditor and the debtor in corresponding fiduciary capacities or roles with respect to one another.[13]

---

[9] *See, e.g., Official Comm. of Unsecured Creditors v. Mfrs. & Traders Trust Co. (In re Bennett Funding Grp., Inc.)*, 146 F.3d 136, 139 (2d Cir. 1998); *Westinghouse Credit Corp. v. D'Urso*, 278 F.3d 138, 149 (2d Cir. 2002); (*In re SemCrude, L.P.*, 399 B.R. 388, 393 (Bankr. D. Del. 2009) (for purposes of section 553, debts are "'mutual' only when 'they are due to and from the same persons in the same capacity'"), *aff'd*, 428 B.R. 590 (D. Del. 2010); *Scherling v. Hellman Elec. Corp. (In re Westchester Structures)*, 181 B.R. 730, 739 (Bankr. S.D.N.Y. 1995); *Westinghouse Credit Corp.*, 278 F.3d at 149; *Davidovich v. Welton (In re Davidovich*), 901 F.2d 1533, 1537 (10th Cir. 1990); *see also* Philip D. Anker, Jeannette K. Boot & Katelyn Rood, *Outer Bounds of Safe Harbors: Lehman-Swedbank Decision Limits Setoff Rights Under Swap Agreements*, WILMERHALE BANKR. & FIN. RESTRUCTURING ALERT, June 2010, available at http://www.wilmerhale.com/files/upload/Outer_Bounds_of_Safe_Harbors.pdf.

[10] 5 COLLIER ON BANKRUPTCY ¶ 553.03[d] (16th ed. 2011).

[11] *Kleinsmith v. Alcoa Emps. & Cmty. Credit Union (In re Kleinsmith)*, 361 B.R. 504, 508 (Bankr. S.D. Iowa 2006).

[12] 5 COLLIER ON BANKRUPTCY ¶ 553.03[3][b] (16th ed. 2011); *see also In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009).

[13] 5 COLLIER ON BANKRUPTCY ¶ 553.03[3][c] (16th ed. 2011).

The burden of proving mutuality is on the claimant,[14] and courts have recently held that the mutuality requirement should be strictly construed.[15] For example, in *Chevron Prods. Co. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 428 B.R. 590 (D. Del. 2010), the District Court for the District of Delaware disallowed "triangular setoff" due to lack of mutuality among the parties. In *Swedbank AB v. Lehman Brothers Holdings Inc.*, No. 10-cv-4532 (S.D.N.Y. Jan. 26, 2011), the District Court for the Southern District of New York held that the Bankruptcy Code derivatives safe harbor provisions do not create an exception to the section 553 mutuality requirements. The rationale behind a strict construction of mutuality is that "[a] narrow interpretation of mutuality ensures that setoff is allowed only in situations in which the equitable considerations are strongest: namely where the claims or debts are owed between the same parties in the same right or capacity."[16]

C. Limitation of Setoff Rights

There are exceptions to setoff, contained in section 553(b) of the Bankruptcy Code, which "is founded on the policy goal of discouraging creditors from artificially creating or enlarging their right to setoff during a debtor's slide into bankruptcy."[17] Section 553(b)(1) "contain[s] a limitation on pre-petition transactions when the net effect of a setoff during the 90 days preceding bankruptcy allows a creditor to improve its position in a manner not permitted by the Code."[18]

"The limitation on setoff in §553(b)(1) is designed to prevent a creditor who may believe that a customer is sliding into insolvency from creating an obligation to the customer during the preference period for the purpose of improving its position through a setoff remedy."[19] Capturing a principle similar to the law of avoidable preferences, the improvement-in-position test of section 553(b) provides, in pertinent part, that if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency as of the date of such setoff is less than the insufficiency on the later of (A) 90 days before the date of the filing of the petition and (B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.[20]

---

[14] *In re Lehman Bros. Holdings Inc.*, 404 B.R. at 758; *In re Garden Ridge Corp.*, 338 B.R. at 632; *In re Lason, Inc.*, 314 B.R. 296, 305 (Bankr. D. Del. 2004); *Official Comm. of Unsecured Creditors v. Mfrs. & Traders Trust Co. (In re Bennett Funding Grp.)*, 212 B.R. 206, 212 (B.A.P. 2d Cir. 1997), *aff'd*, 146 F.3d 136 (2d Cir. 1998).
[15] 5 COLLIER ON BANKRUPTCY ¶ 553.02(3) (15th ed. 2011); *In re Garden Ridge Corp.*, 338 B.R. at 632.
[16] *Shugrue v. Fischer (In re Ionosphere Clubs)*, 164 B.R. 839, 843 (Bankr. S.D.N.Y. 1994).
[17] Ben Caughney, *A Creditor's Right to Setoff: When Does a Creditor Impermissibly Improve its Position?*, ABI J., Dec./Jan. 2011, at 32.
[18] *Id.*
[19] Ben Caughney, *A Creditor's Right to Setoff: When Does a Creditor Impermissibly Improve its Position?*, ABI J., Dec./Jan. 2011, at 32.
[20] 11 U.S.C. § 553(b).

"Insufficiency" is defined as the amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.[21]

Additionally, pursuant to section 553(a)(2) of the Bankruptcy Code, a bankruptcy court can deny setoff if entities other than the debtor transferred their claims to a creditor "(A) after the commencement of the [bankruptcy] case; or (B) (i) after 90 days before the date of the filing of the petition [for bankruptcy]; and (ii) while the debtor was insolvent,"[22] excluding certain safe harbor transfers not applicable here. Pursuant to section 553(a)(3) of the Bankruptcy Code, a bankruptcy court can deny setoff to a creditor if "the debt owed to the debtor by such creditor was incurred by such creditor—(A) after 90 days before the date of the filing of the petition; (B) while the debtor was insolvent; and (C) for the purpose of obtaining a right of setoff against the debtor" excluding certain safe harbor setoffs not applicable here.[23]

II. Transactions among the ISO and Market Participants[24]

A. Current Arrangements

The ISO currently "operates the New England Transmission System pursuant to [that] certain Transmission Operating Agreement dated February 1, 2005, and other agreements entered into with merchant and other transmission owners. The ISO's operation of the New England Transmission System is intended to insure the reliability of the New England Transmission System. Subject to the requirements of bulk power supply reliability, the ISO provides non-discriminatory, open access to the New England Transmission System pursuant to the ISO's Transmission, Markets and Services Tariff on file with the . . . [Commission] (as amended from time to time, the "Tariff")."[25] In addition, the ISO "operates competitive markets for the purchase and sale of energy, capacity, certain demand response services, certain Ancillary Services and certain related products and services pursuant to the Tariff."[26]

Pursuant to the Market Participant Service Agreement (the "MPSA"), which is signed by each Market Participant in connection with the Tariff, each Market Participant currently "appoints the ISO as its agent to apportion, bill and collect on its behalf for Energy, capacity, Ancillary Services, demand response services or other related products or services sold through the New England Markets in accordance with the ISO New England Operating Documents."[27] Similarly, each "Market Participant appoints the ISO as its agent to purchase on its behalf

---

[21] 11 U.S.C. § 553(b)(2).
[22] 11 U.S.C. § 553(a)(2).
[23] 11 U.S.C. § 553(a)(3).
[24] Capitalized terms used in this Section II and not defined herein shall have the meanings ascribed to them in the Tariff or the Amended Tariff (as defined below), as applicable.
[25] Market Participant Service Agreement, Background, Section A.
[26] Market Participant Service Agreement, Background, Section B.
[27] MPSA, Article IV—Provisions Relating to Sellers, Section 4.1—Appointment of the ISO as Agent.

Energy, capacity, Ancillary Services, demand response services or other related products or services through the New England Markets in accordance with the ISO New England Operating Documents."[28]

- *The ISO as Collection Agent*. Pursuant to the MPSA, "The ISO agrees to apportion, bill and collect for Market Participant's services and to remit to [a] Market Participant amounts due to it under the Market Rules, as and when collected. The ISO will use commercially reasonable efforts to collect amounts due to [a] Market Participant, including exercising its rights under the ISO New England Financial Assurance Policy and ISO New England Billing Policy. Allocation of revenues received will be made, and all disputes regarding amounts collected and remitted will be handled in accordance with the ISO New England Operating Documents."[29]
- *The ISO as Remitting Agent*. Currently, pursuant to the ISO's Billing Policy, the ISO also acts as a remitting agent for the Market Participants.[30]
- *Security Agreement*. Security Agreements issued in connection with the ISO's Financial Assurance Policy are executed in favor of the ISO as the secured party, which signs "in its individual capacity and as agent for the Market Participants."[31]
- *Letters of Credit*. Standby Letters of Credit issued in connection with the ISO's Financial Assurance Policy are executed in favor of the ISO, "in its individual capacity and on behalf of the participants in the ISO's Markets. . . ."[32]

Pursuant to the Tariff, each "Customer is obligated to pay when due in accordance with the Tariff, the ISO New England Financial Assurance Policy and the ISO New England Billing Policy all amounts invoiced to it pursuant to th[e] Tariff, and to comply with those terms, conditions and policies in all respects. If a Customer fails to meet the requirements specified in the ISO New England Financial Assurance Policy and the ISO New England Billing Policy, the ISO may take such actions as are specified in those policies."[33]

- *Financial Assurance Policy*. The ISO's Financial Assurance Policy establishes procedures through which the ISO can regulate the Market Participants' credit worthiness and thereby "protect the ISO and the Market Participants against the risk of non-payment by other, defaulting Market Participants or by Non-Market Participant Transmission

[28] MPSA, Article V—Provisions Relating to Buyers, Section 5.1—Appointment of the ISO as Agent.
[29] MPSA, Article IV—Provisions Relating to Sellers, Section 4.2—Collection.
[30] Tariff, Section I, Exhibit ID—ISO New England Billing Policy, Section 1.2—Financial Transaction Conventions.
[31] Tariff, Section I, Exhibit IA—ISO New England Financial Assurance Policy, Attachment 1, Sample Security Agreement.
[32] Tariff, Section I, Exhibit IA—ISO New England Financial Assurance Policy, Attachment 2, Sample Letter of Credit.
[33] Tariff, I.3.7—Payment of Invoices; Compliance with Policies.

Customers."[34] The Financial Assurance Policy provides the ISO with the authority to, among other things, "collect amounts past due, to collect amounts payable upon billing adjustments, to make up shortfalls in payments, to suspend Market Participants . . . that fail to comply with the terms of the ISO New England Financial Assurance Policy, [and] to terminate the membership of defaulting Market Participants . . . ."[35]

- *Billing Policy*. The Billing Policy sets forth procedures through which the ISO will attempt to recover from defaulting Covered Entities[36] with respect to ISO Charges (Section 3.3) and Transmission Charges (Section 3.4). These procedures include using "set-offs," using the financial assurances provided by the security interest granted to the ISO in connection with the Financial Assurance Policy and taking legal action.[37] These procedures allow the ISO to socialize the default risk among the Covered Entities, however, "[e]ach Covered Entity that shared in any shortfall in payments under Section 3.3 or Section 3.4 shall have an independent right to seek and obtain payment and recovery of the amount of its share of such shortfall (the 'Allocated Assessment') from the defaulting Covered Entity." Any such recovery is then applied to such Covered Entity's share of any recovery of a shortfall in payments.[38]

The ISO's current structure as agent to the Market Participants for certain transactions may create enforceable setoff rights in bankruptcy. However, there are no cases directly on point, and litigants could challenge such setoff rights based on the mutuality condition. The ISO intends to amends its Tariff to create a CCP structure and establish enforceable setoff rights in bankruptcy.

B. Future Arrangements

Based on information provided by the ISO, the following is our understanding of changes that will be made to the Tariff to make the ISO the direct contracting party in certain transactions with Customers (defined as "a Market Participant, a Transmission Customer or another customer of the ISO") constituting the purchase and sale of electricity in which the ISO takes title to all electricity that is purchased or sold ("Sale Transactions"):

---

[34] Tariff, Section I, Exhibit IA—ISO New England Financial Assurance Policy, Overview.
[35] Tariff, Section I, Exhibit IA—ISO New England Financial Assurance Policy, Overview.
[36] The definition of "Covered Entities" includes the ISO and Market Participants. Tariff, Section I, Exhibit ID—ISO New England Billing Policy, Section 1.1—Scope.
[37] Tariff, Section I, Exhibit ID—ISO New England Billing Policy, Section 3.3—Payment Default for ISO Charges, and Section 3.4—Payment Default for Transmission Charges.
[38] Tariff, Section I, Exhibit ID—ISO New England Billing Policy, Section 3.5—Enforcement of Payment Obligations Against Defaulting Covered Entities.

The ISO intends to amend its Tariff (the "Amended Tariff") to make clear that it will be a CCP to certain electricity transactions with its Customers[39] in which the ISO will take title to all electricity that is purchased and sold, and will become a buyer to each market seller and a seller to each market buyer. In such capacity, the ISO will "act[ ] as the contracting party, in its name and own right and not as an agent, to an agreement or transaction with a Customer (including assignments involving Customers) involving sale to the ISO, and/or purchase from the ISO, of Regional Transmission Service and market and other products and services, and other transactions and assignments involving Customers, all as described in the Tariff."[40] The purpose of this planned revision is to make clear that there is a single, specific counterparty to the ISO's Customers with respect to the foregoing electricity transactions, including Sale Transactions.

- *The ISO as Counterparty*. In the Amended Tariff, "[t]he ISO acts as Counterparty for sales to its Customers of Regional Transmission Service, and for agreements and transactions with its Customers, including but not limited to assignments involving Customers, and agreements and transactions with Customers involving sale to the ISO and/or purchase from the ISO of energy, capacity, reserves, regulation, Ancillary Services, FTRs and other products, service and transactions, all as specified in Sections II and III of the Tariff (collectively, the 'Products')."[41]
- In the Amended Tariff, Payment will be defined as "a sum of money due to a Covered Entity from the ISO" (and *not* "from the ISO, as remitting agent for the Covered Entities").[42]
- *Letters of Credit.* In the Amended Tariff, Standby Letters of Credit issued in connection with the ISO's Financial Assurance Policy will no longer be executed in favor of the ISO, "on behalf of the participants in the ISO's Markets and the Participating Transmission Owners ('PTOs') whose facilities are operated by the ISO." Instead, they will be executed in favor of the ISO, without reference to the ISO's acting on behalf of those parties.[43]

---

[39] "Customers" is defined as "a Market Participant, a Transmission Customer or another customer of the ISO." Amended Tariff, Section I.2.2—Definitions

[40] Amended Tariff, Section I.2.2—Definitions.

[41] Amended Tariff, Section I.3—Obligations of Market Participants and Other Customers. We note, however, that pursuant to the Amended Tariff, "[t]o the extent permitted by applicable law, any warranties provided by the sellers or assignors to the ISO of the Products which cover the Products, whether express or implied, are hereby passed to the Customers on a 'pass through basis' and to the extent not passed through, any such warranties are hereby assigned by [the] ISO to Customers. Sellers and assignors to the ISO and Customers acknowledge that warranties on such Products are limited to that offered by the seller or assignor to the ISO and will exist, if at all, solely between the seller or assignor to the ISO and the Customer." *Id*.

[42] Amended Tariff, Section I.2.2—Definitions (compared to Tariff, Section I.2.2—Definitions).

[43] Amended Tariff, Section I, Exhibit IA—ISO New England Financial Assurance Policy, Attachment 2, Sample Letter of Credit.

- *Security Agreement*. Similarly, in the future, each time the ISO enters into a Security Agreement with a debtor in connection with the ISO's Financial Assurance Policy, the ISO will be signing without reference to acting as an agent for the Market Participants.[44]

Pursuant to the Amended Tariff, each Customer remains "obligated to pay when due in accordance with th[e] Tariff, the ISO New England Financial Assurance Policy and the ISO New England Billing Policy all amounts invoiced to it pursuant to th[e] Tariff, and to comply with those terms, conditions and policies in all respects. If a Customer fails to meet the requirements specified in the ISO New England Financial Assurance Policy and the ISO New England Billing Policy, the ISO may take such actions as are specified in those policies."[45]

- *Billing Policy*. In the Amended Tariff, the ISO will no longer "act as agent for the other Covered Entities . . ., in administering, managing and enforcing the ISO New England Billing Policy."[46] In the Amended Tariff, the Billing Policy defines Payment as "a sum of money due to a Covered Entity from the ISO . . . ."[47] As in Section I of the Amended Tariff, this definition no longer refers to the ISO as remitting agent for the Covered Entities.

- *Payment Default for ISO Charges and Transmission Charges.* The Billing Policy's procedures through which the ISO will attempt to recover from defaulting Covered Entities with respect to ISO Charges (Section 3.3) and Transmission Charges (Section 3.4) are not changed in the Amended Tariff. Payment defaults will continue to be mutualized by the pool of participants in the ISO, and the Amended Tariff states that "Each Covered Entity consents to other Covered Entities' having [the] independent right" to "seek and obtain payment and recovery of the amount of its share of . . . a shortfall in payments."[48]

Section II of the Amended Tariff contains the Open Access Transmission Tariff and includes new language to make clear that "[t]he ISO acts as Counterparty for sales to its Customers of Regional Transmission Service and Ancillary Services, and as Counterparty with suppliers of Ancillary Services. The ISO offers Regional Transmission Service, as made available to the ISO under the terms of the TOA for provision to its Customers, at the rates established by the PTOs. Where Ancillary Services are initially supplied to the ISO by Market Participants for provision to the ISO's Customers, the ISO pays to or charges its Market

[44] Amended Tariff, Section I, Exhibit IA—ISO New England Financial Assurance Policy, Attachment 1, Sample Security Agreement.
[45] Amended Tariff, I.3.7—Payment of Invoices; Compliance with Policies.
[46] Amended Tariff, Section I, Exhibit ID—ISO New England Billing Policy, Section 1—Overview.
[47] Amended Tariff, Section I, Exhibit ID—ISO New England Billing Policy, Section 1.2(b).
[48] Amended Tariff, Section I, Exhibit ID—ISO New England Billing Policy, Section 3.5—Enforcement of Payment Obligations Against Defaulting Covered Entities.

Participants or Customers (as applicable) the amounts produced by the pertinent market clearing process or through the other pricing mechanisms described in the Tariff."[49]

We have been advised by the ISO that throughout Section II of the Amended Tariff, revisions will be made to make clear that Customers will be purchasing Ancillary Services *from* the ISO, instead of *through* the ISO.[50] Similarly, in connection with certain services such as "Through or Out Service," discounts will be made by the PTOs "through the ISO" instead of directly to Customers.[51]

As a counterparty to each Sale Transaction in which the ISO takes title, each Market Participant in the ISO will have a credit relationship only with the ISO, rather than with every other Market Participant in the ISO. With this counterparty structure in place, the seller and buyer will be known in each transaction, and the ISO will always be the other counterparty to each obligation.

C. Central Counterparties and the Mutuality Requirement

CCPs foster market liquidity by preserving trade anonymity, standardizing contracts, lowering counterparty risk and reducing monitoring costs.[52] CCPs have proven to be effective in various global and domestic financial markets, and "[g]iven the resilience of markets that operate with a CCP, many authorities [including FERC] have recently advocated in favor of extending the use of CCP clearing to other markets."[53] CCPs are not foolproof however, as CCPs can fail on their obligations in the same way that any counterparty can fail, especially because the risk is heavily concentrated in the CCP.

As a party to all transactions, CCPs have mutual relationships with all market participants and are in a strong position to uphold setoff in bankruptcy court. In the bankruptcy context, "[t]he problem of mutuality is solved by the ingenious device of inserting a company, the central counterparty, between the participants and the bankrupt [debtor]."[54] Philip Wood of Allen & Overy explained that the result of a CCP arrangement like the one proposed by the ISO

---

[49] Amended Tariff, Section II.2—Purpose of This OATT.
[50] *See, e.g.*, Amended Tariff, Section II.4—Ancillary Services.
[51] Amended Tariff, Section II, Schedule 8—Through or Out Service; The Pool PTF Rate.
[52] Cyril Monnet, *Let's Make it Clear: How Central Counterparties Save(d) the Day*, BUS. REV., Q1 2010, at 5.
[53] *Id.* at 6.
[54] Philip Wood, *What is a Central Counterparty in Financial Markets?* ALLEN & OVERY, Aug. 20, 2009, available at http://www.allenovery.com/AOWEB/AreasOfExpertise/Editorial.aspx?contentTypeID=1&itemID=52783&prefLangID=410

> "is that, if [a participant] becomes bankrupt, the central counterparty can set off or net against [that participant] since all the trades are mutual as between the central counterparty and [that participant]. . . . The effect is that a global set-off by all participants against the bankrupt [participant] becomes possible. The reduction of overall risk in many cases can be simply enormous."[55]

In other words, "[t]he effect [of using a CCP] is that all trades which a defaulting member would otherwise have had with the other members—and which could not be netted on insolvency because of the lack of mutuality—become instead trades between the defaulter and the central counterparty that are mutual and hence eligible for netting."[56] "Hence the use of the central counterparty substantially reduces market exposures."[57]

There is not yet any United States case law specifically addressing the setoff rights of a CCP in bankruptcy. However, an analyst recently suggested "that the customs and practices of CCPs provide for the immediate and instantaneous creation of mutuality between the CCP and the clearing members."[58] In a different article, the same analyst further opined that

> domestic corporate insolvency laws should not interfere with and hinder crucial risk management operations of CCP systems, such as multilateral netting and close-out netting upon the insolvency of a clearing member or the CCP. This would defeat the purpose of having a CCP system in the first place. CCPs operating in common law jurisdictions have already achieved bankruptcy resistance through the development of contractual netting, which allows CCPs to satisfy the "mutuality" requirement for achieving insolvency set-off.[59]

We note that simply changing the name of a party—from "agent" to "counterparty"—will not achieve the desired result with respect to setoff. Nor will it suffice for contracting parties to

---

[55] *Id.*
[56] PHILIP R. WOOD, SET-OFF AND NETTING, DERIVATIVES, CLEARING SYSTEMS 97-98 (2d ed. 2009).
[57] Philip R. Wood, *Legal Impact of the Financial Crisis: A Brief List*, 4 CAP. MARKETS LAW J. 436, 443 (2009) ("The effect of [using a CCP] is that if [a counterparty] 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.")
[58] Christian Chamorro-Courtland, *Counterparty Substitution in Central Counterparty (CCP) Systems*, 26 BANKING & FIN. L. REV. 517, 525 (2011).
[59] Christian Chamorro-Courtland, *Central Counterparties (CCP) and the New Transnational Lex Mercatoria*, 10 FLA ST. U. BUS. REV. 57, 62 (2011).

simply "assign" their respective obligations to the CCP. For setoff to be effective, the CCP must actually have direct and mutual obligations with the insolvent counterparty.[60]

III. The ISO and Setoff

Through its new counterparty structure in which the ISO will take title to electricity and become the buyer to each market seller and seller to each market buyer, the ISO will establish mutuality between itself and its market participants in Sale Transactions to best ensure the enforceability of netting and setoff of a market participant's debits and credits in a default situation. In turn, this will reduce the risk of exposure of other participants to default.

Although this is a new structure for the ISO and the industry, and has not been tested in the courts, we know of no precedent holding that the use of such a counterparty structure in Sale Transactions would not be upheld in bankruptcy.

This Memorandum was written for ISO New England in connection with its submission to the Commodity Futures Trading Commission of an Application for an Exemptive Order Under Section 4(c) of the Commodity Exchange Act. No person or entity may rely on this Memorandum without the prior written consent of Wilmer Cutler Pickering Hale and Dorr LLP.

[60] For additional analysis regarding CCP structures and setoff in a bankruptcy context, *see* Harold A. Novikoff, Philip Mindlin, Joshua A. Feltman & Jane VanLare, *Memorandum: Setoffs and Credit Risk of PJM in Member Bankruptcies*, March 17, 2008, available at http://pjm.com/committees-and-groups/subcommittees/~/media/committees-groups/subcommittees/cs/postings/wachtell-netting-memorandum.ashx.