MEMORANDUM

July 18, 2011

TO: PJM Interconnection, L.L.C.

FROM: Wachtell, Lipton, Rosen & Katz

RE: Legal Basis for Setoffs By PJM Settlement

PJM Interconnection, L.L.C. ("PJM") has asked us to assess whether its designation of a central counterparty for pool transactions in PJM markets satisfies the mutuality condition necessary to assert setoff rights in the event of a bankruptcy of a PJM member. It is our view that a judge, properly presented with the question, would find that the central counterparty structure implemented in accordance with the documents provided to us by PJM would give rise to enforceable rights of setoff of the central counterparty (PJM Settlement, as defined below) against its counterparties under Title 11 of the United States Code (the "Bankruptcy Code") in the event of the bankruptcy of any such counterparty.

Part I of this memorandum addresses the conditions that must be met for the recognition of enforceable setoff rights generally. Part II reviews at a high level the current and former positions of PJM in the markets it administers. Part III applies the law of mutuality in setoff to central counterparty structures generally and the new PJM structure, as it has been described to us, specifically.

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 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.'"[1] "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."[2] Such rights help "avoid a multiplicity of suits, added expense, inconvenience, injustice and inefficient use of judicial resources."[3]

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[1] *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)).
[2] 5 *Collier on Bankruptcy* ¶ 553.02 (16th ed. 2010).
[3] 5 *Collier on Bankruptcy* ¶ 553.01 (16th ed. 2010).

Such considerations were recognized by Congress in adopting the Bankruptcy Code, which provides that, as a general proposition, the Bankruptcy Code "does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor."[4] Indeed, the Bankruptcy Code elevates claims of creditors having the benefit of enforceable rights of setoff against amounts owing to the debtor to the status of "secured claims"[5] (secured, in effect, by the value of the claim the debtor holds against the creditor).

At the same time, "because setoffs run contrary to fundamental bankruptcy policies such as the equal treatment of creditors and the preservation of a reorganizing debtor's assets,"[6] Section 553 and the caselaw interpreting it make clear that setoff rights are only enforceable subject to certain qualifications and exceptions.[7] 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 Code does not define "mutual," courts have developed a test for determining whether mutuality exists. To be mutual the debts must be (i) between the same parties, standing (ii) in the same right and (iii) 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. A common situation where courts have found mutuality to be lacking is that of a "triangular setoff,"[11] in which A owes a debt to B who owes a debt to C, and

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[4] 11 U.S.C. § 553

[5] 11 U.S.C. § 506(a).

[6] *Newbery Corp.* v. *Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1399 (9th Cir. 1996).

[7] Moreover, section 553 does not create an independent right of setoff under the Bankruptcy Code; it merely recognizes state-law rights that otherwise satisfy the requirements of the section. *In re Chateaugay Corp.*, 94 F.3d 772, 777 (2d Cir. 1996); *In re Bevill, Bresler & Schulman Asset Management Corp.*, 896 F.2d 54, 57 (3d Cir. 1990). Note that even state law tends to cabin setoff rights to some extent, despite bankruptcy policies not being explicitly at issue – of concern is that setoff rights effectively constitute a "secret lien"; i.e., a lien which, unlike liens governed by the uniform commercial code, is not required to be publicly disclosed in order to be effective against third parties and from which, therefore, third parties cannot protect themselves.

[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).

[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 SemCrude L.P.*, 399 B.R. 388 (D. Del. 2009); *In re Hill Petroleum Co.*, 95 B.R. 404, 411 (Bankr. W.D. La. 1988).

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 these requirements interchangeably, "in the same right" means that an obligation 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] Thus, setoff has been disallowed where the creditor sought to setoff its own obligations against funds that he held in trust for another party.[18] "The distinction between the concept of '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."[19]

II. Transactions Among PJM and its Members

A. Former Arrangements

In 2008, PJM asked us to assess its exposure to credit risks in the case of Member bankruptcies, specifically considering whether transactions on the PJM market satisfied the conditions described above for enforceable setoff rights. In a memorandum to PJM on March 17,

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[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 Berger Steel Co.*, 327 F.2d 401, 408 (7th Cir. 1964); *In re Balducci Oil Co.*, 33 B.R. 847, 852-53 (Bankr. 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] *Id.* The concept is long-standing. *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).

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

[18] *In re Bevill, Bresler & Schulman Asset Management Corp.*, 896 F.2d at 57; *In re Texas Mortgage Services Corp.*, 761 F.2d 1068, 1075 (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").

[19] 5 *Collier on Bankruptcy* ¶ 553.03 (15th ed. 2008).

2008,[20] we concluded that "there is a substantial risk that PJM, if challenged, would be prohibited from setting off outstanding charges to a bankrupt Member against outstanding payments owing to the Member (or would be incentivized to settle any such challenge at a material cost)."[21]

We cited three interrelated reasons for reaching that conclusion, all centered around the principle of mutuality. First, PJM's description of its operations suggested that it was not acting as a principal in the energy market it administered and, in fact, included explicit disclaimers to the effect that "PJM does not: Take ownership of the energy on the system."[22] Second, the principal agreements governing the PJM Interchange Energy Market, including the PJM Open Access Transmission Tariff, the PJM Amended and Restated Operating Agreement, and the Transmission Owners Agreement, were ambiguous with respect to issues of title to both funds and power as they flowed through PJM's accounting and transmission systems. Third, we observed that PJM's principal regulator, the Federal Energy Regulatory Commission ("FERC") seemed to think of independent system operators such as PJM as a conduit or pass-through.

B. Current Arrangements

We understand that subsequent to our 2008 memorandum PJM submitted amendments to its operating agreement and tariff (as amended, respectively, the "Amended Operating Agreement" and the "Amended Tariff") to FERC for the purpose of rectifying the above concerns by establishing a new subsidiary, PJM Settlement, Inc. ("PJM Settlement"), as the central counterparty to transactions in the PJM markets. According to PJM's filing with FERC, "The purpose of the filed revisions is to clarify that there is a single, specified counterparty to market participants with respect to all 'pool' transactions in the markets operated by PJM and for transmission service."[23] We understand that PJM Settlement commenced operations as a new public utility on January 1, 2011, as accepted in a December 30, 2010 order of FERC.[24]

We further understand that, in implementing the amended tariff and operating agreement, PJM sought to provide that:

- PJM Settlement takes "title to all power that is purchased and sold in the 'pool transactions' in the [PJM-administered] markets"[25];

- "PJM Settlement will be a buyer to each market seller and a seller to each market buyer, *taking title to electricity and other products and assuming liability for payables, in its own name and right*"[26]; and

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[20] Memorandum of Wachtell, Lipton, Rosen & Katz to PJM regarding Setoffs and Credit Risk of PJM in Member Bankruptcies (Mar. 17, 2008) available at http://www.pjm.coml-/medialcommitteesgroups/committees/crmsc/20080423/20080423-wachtell-netting-memo.ashx.

[21] Wachtell, Lipton, Rosen & Katz memorandum, Marc 17, 2008, p. 9.

[22] "PJM 101," presentation dated October 4, 2007, p. 16 (http://www.pjm.com/services/training/downloads/pjm101part1.pdf).

[23] PJM Filing with FERC, *PJM Interconnection, L.L.C., and PJM Settlement, Inc.*, May 5, 2010, Docket No. ER10-1196-000, p.1.

[24] Docket Nos. ER10-1196-001, ER11-1987-000, ER11-1988-000, ER11-1988-001

[25] PJM Filing with FERC, *PJM Interconnection, L.L.C., and PJM Settlement, Inc.*, May 5, 2010, Docket No. ER10-1196-000, p. 9.

- the interposition of PJM Settlement as a counterparty in PJM-administered markets does not extend to certain bilateral contracts and self-supply transactions (which PJM considers to be non-pool transactions).[27]

We have examined certain documents which PJM has represented to us as governing the relationship between PJM members and PJM Settlement in connection with applicable transactions,[28] including the Amended Operating Agreement and the Amended Tariff. We note that all PJM members are party to the Amended Operating Agreement, and we assume the enforceability of their obligations thereunder; we are advised by PJM that the Amended Tariff has been properly approved by FERC.

The Amended Operating Agreement provides, among other things:

1. "As specified in Section 11 and Schedule 4, Members agree that PJMSettlement is the Counterparty to certain transactions as specified in this Agreement and the PJM Tariff (Sec. 3.3)";

2. "'Counterparty'" shall mean PJMSettlement as the contracting party, in its name and own right and not as an agent, to an agreement or transaction with Market Participants or other entities, including the agreements and transactions with customers regarding transmission service and other transactions under the PJM Tariff and this Operating Agreement (Sec. 1.7.01a)"; and

3. "Each Member shall receive from PJMSettlement (and not from any other party), and shall pay to PJMSettlement (and not to any other party), the amounts specified in the PJM Tariff and this Agreement for services and transactions for which PJMSettlement is the Counterparty, and PJMSettlement shall be correspondingly obliged and entitled" (Sec. 14B.4).

The Amended Tariff also provides for corresponding amendments to various ancillary PJM agreements, including Transmission Service Agreements.

The Amended Tariff provides, among other things:

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[26] PJM Filing with FERC, *PJM Interconnection, L.L.C., and PJM Settlement, Inc.*, May 5, 2010, Docket No. ER10-1196-000, p. 9 (emphasis added).

[27] *Id.*

[28] In sum, "For purposes of contracting with customers and conducting financial settlements regarding the use of the transmission capacity of the Transmission System, the LLC has established PJMSettlement. The LLC also has established PJMSettlement as the entity that is the Counterparty with respect to the agreements and transactions in the centralized markets that the LLC administers under the Tariff and the Operating Agreement (i.e., the agreements and transactions that are not bilateral arrangements between market participants or self-supply). PJMSettlement will serve as the Counterparty to Financial Transmission Rights and Auction Revenue Rights instruments held by a Market Participant. Any subsequent bilateral transfer of these instruments by the Market Participant to another Market Participant shall require the consent of PJMSettlement, but shall not implicate PJMSettlement as a contracting party with respect to such subsequent bilateral transfer." *Amended and Restated Operating Agreement of PJM Interconnection, L.L.C.* (effective as of 6/1/11), Sec. 3.3(b).

1. "Under the Tariff and Operating Agreement, PJM administers the provision of transmission service and associated ancillary services to customers and operates and administers various centralized electric power and energy markets. In obtaining transmission service and in these centralized markets, customers conduct transactions with PJMSettlement as a counterparty" (Sec. 6A.1);

2. "Unless otherwise expressly stated in the Tariff or the Operating Agreement, PJMSettlement shall be the Counterparty to the customers purchasing Transmission Service and Network Integration Transmission Service, and to the other transactions with customers and other entities under the Tariff" (Sec. 6A.4);

3. "Under the Tariff and Operating Agreement, PJMSettlement is the entity that (i) contracts with customers and conducts financial settlements regarding the use of the transmission capacity of the Transmission System that PJM, as the Transmission Provider, administers under the Tariff and Operating Agreement; (ii) is the Counterparty with respect to the agreements and "pool" transactions in the centralized markets that PJM, as the Transmission Provider, administers under the Tariff and Operating Agreement; and (iii) is the Counterparty to Financial Transmission Rights and Auction Revenue Rights instruments held by a Market Participant" (Attachment HH).

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 the lack of mutuality—become instead trades between the defaulter and the central counterparty that are mutual and hence eligible for netting...[29]

The same author, a scholar and special counsel to the English firm of Allen & Overy, has written elsewhere that "[t]he problem of mutuality is solved by the ingenious device of inserting a com-

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[29] 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 138 ("Thus, the use of a central counterparty enables a multilateral netting scheme to maintain the requirement of mutuality between parties.").

pany, the central counterparty, between the participants and the bankrupt X."[30] 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"[31] 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.[32] CLS Bank operates the largest multi-currency cash settlement system to eliminate settlement risk in the foreign exchange market,[33] serving as counterparty to trades in total amounts many times more than world GDP, but is able to reduce its risk exposure by roughly 95 percent by availing itself of the benefits of netting and setoff rights.[34] NSCC, a subsidiary of the Depository Trust 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.[35] 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.[36] When an affiliate of NSCC, the Fixed Income Clearing Corporation ("FICC") announced plans to develop central counterparty capabilities with respect to the mortgage-backed-securities market, it observed, "[w]hen 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."[37]

B. Caselaw

Notwithstanding the consensus view described above, it is not difficult to imagine arguments against mutuality with central counterparties. The thrust of such arguments would be that a designated central counterparty such as PJM Settlement is not an economic actor (i.e., not transacting for profit, not subject to true risk of loss), but a mere conduit acting in an agency capacity – mutuality is absent, the argument runs, because the central counterparty is not "really" transacting with anyone or, if it is, then it is acting in a variable capacity that renders setoff (a right that policy requires be cabined) inappropriate.

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[30] 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

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

[32] *Id.* at 99.

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

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

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

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

[37] "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.

Nor is it difficult to imagine the rejoinders: economic risk is irrelevant (any number of firms not technically constituting central counterparties may be hedged in relevant transactions, not least market maker-type firms that work for spreads but are not exposed to any risk other than counterparty risk, exactly as with PJM Settlement); to say that a central counterparty is not really transacting is to say that the law should treat the millions of transactions which it executes as being somehow unilateral, since no other party could be identified in lieu of the central counterparty (precisely the fiction embedded in the pre-2011 PJM settlement system that led us to question that system's ability to sustain an enforceable setoff policy); a central counterparty acts on its own behalf, so it always acts in the same capacity and the law generally respects corporate and contractual forms.

Unfortunately, while there are many cases addressing the applicability of setoff rights between conventional contracting parties,[38] we have not come across a case specifically involving a challenge to the setoff rights of a central counterparty. However, various cases have been decided that we believe are suggestive of how a court, directly confronted with the central counterparty question, would rule.

In 2006 the US Bankruptcy Appellate Panel of the 9th Circuit heard a case, *In re Coast Grain Co.*,[39] that is suggestive of how courts might treat PJM Settlement if there were a challenge to its assertion of setoff rights. Coast Grain Co. ("Coast Grain") was a retailer for livestock feed, selling products on fixed-price and spot market contracts to dairy farms in the western United States, but with two idiosyncrasies in its business model. First, the company's "prepayment program" allowed customers to deposit cash with the company irrespective of whether orders were pending and receive discounts (in effect, interest on the deposit) on orders subsequently made and fulfilled. Second,

> Without restriction, Coast Grain would, upon instruction from the customer, make payments from the prepayment account to third parties on the customer's behalf... Although most customers made purchases during the year from Coast Grain, under this arrangement, customers were free to direct Coast Grain to pay third parties any sum up to the entire amount of the prepayment deposit, plus all accumulated interest. There were no restrictions on the types of persons or entities to whom a customer could direct a third party payment...[40]

Put another way, Coast Grain, as a service to its customers, took on some of the obligations of a central counterparty, but even more explicitly intermediating between specific customers and third parties specifically identifiable to them.

The controversy in the case concerned the applicability of Section 553(a)(3) (unenforceability of setoffs by a creditor where creditor's claims were acquired for the purpose of creating such setoff in the 90 days prior to the debtor's bankruptcy) to Coast Grain customer

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[38] *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).

[39] *In re Coast Grain Co.*, 2006 WL 6810917 (9th Cir. BAP (Cal.)).

[40] *Id.* at 1.

Bouma. The bankruptcy appellate panel had cause to address the mutuality question, upholding the bankruptcy court's decision that the:

> conditions required for setoff were present in the transactions between Bouma and Coast Grain: "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."[41]

Notably, the panel did not focus on the relationship of Coast Grain to any third party payee designated by Bouma. It was sufficient to note only that Coast Grain advanced funds or product for Bouma and Bouma had deposited cash with Coast Grain. Mutuality was thereby established, without any inquiry into the details of individual sales, payments to third parties or deposits.

If not perfectly analogous to PJM Settlement, Coast Grain arguably presents a harder case for setoff enforceability. Coast Grain was clearly acting on behalf of customers in connection with specifically identifiable third parties as one of its marketed "services" to customers with prepayment accounts. There is no evidence that Coast Grain stood in the chain of title to goods purchased by Bouma from third parties, despite providing funds for such purchases from prepaid customer deposits. Such arguments as one might fear would be leveled at PJM Settlement's regime to disprove mutuality – acting as an agent or conduit, and so forth – should have been more persuasive in *Coast Grain*.

Similarly, 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,[42] with one relatively recent and favorable case being from Pennsylvania.[43] Hence, a counterfactual claim that PJM Settlement should not be entitled to setoff because a third party from which it received applicable rights and obligations (by hypothesis, another PJM 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 in any event. Per above, we understand that PJM Settlement does not intend to take by assignment transaction obligations initially entered into on a bilateral basis by PJM members.

Finally, while we know of no case involving a central counterparty or clearing agency, we note that Section 362(b)(6) of the Bankruptcy Code provides special protection to the setoff rights of, among other entities, "securities clearing agencies," and that it is generally

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

[42] *In re Photo Mech. Servs., Inc.*, 179 B.R. 604, 613 (Bankr. D. Minn. 1995) (creditor's claim acquired through equitable subrogation satisfies mutuality with debtor); *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). Note, 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; these limitations were at issue in *Coast Grain*, per above.

[43] *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).

agreed that, despite these protections, mutuality is still a pre-requisite to assert such rights.[44] The incremental comfort of these circumstances is minimal, but we note the inference, and what we believe to be the background assumption, that securities clearing agencies are capable of mutuality, notwithstanding their economic role as clearing functionaries rather than market risk takers.

C. PJM

We are of the view that PJM's new operating methods satisfy the conditions for setoff discussed in Part I of this memorandum with respect to the transactions as to which PJM Settlement has been designated as central counterparty.[45] In arriving at this view, we have assumed that (a) the Amended Operating Agreement and Amended Tariff have received all necessary governmental approvals, including that of FERC, (b) PJM in fact operates in accordance with the provisions described above of the Amended Operating Agreement and Amended Tariff, and (c) no other operative provisions of any agreement or tariff among, between or binding on PJM, PJM Settlement and/or the PJM membership, or any of them, conflicts with such provisions. 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 PJM Settlement as a formal contract party, taking title to assets and incurring obligations in its own name, PJM should be able to satisfy this standard.

We know of no precedents that would support the proposition that PJM Settlement should not be entitled to setoff rights because it is somehow not a "true" market participant, not taking economic risk on a net basis, or otherwise. We note that corporate law generally respects formalities, and veil piercing and similar equitable remedies are comparatively rare and limited to extreme cases. We are not aware of any cases or persuasive arguments to the effect that transactions to those PJM Settlement is party are rendered non-mutual because PJM Settlement is ultimately indemnified for losses by PJM members.

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A copy of this Memorandum may be shown to the Commodity Futures Trading Commission for information purposes only, and a complete copy of this Memorandum may be posted on the CFTC's website in connection with PJM's application for an exemption pursuant to Section 4(c) of the Commodity Exchange Act, as amended.

Wachtell, Lipton, Rosen & Katz

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[44] 3 *Collier on Bankruptcy* ¶ 362.05 (16th ed. 2010); *In re Lehman Brothers Holdings Inc.* (Swedbank), 10 CV 4532 (SDNY, January 28, 2011).

[45] See FN 28 above.