McMillan Binch LLP

Derivatives Bulletin

December 2004

Some Further Thoughts on *Enron Australia v. TXU*: Putting the ISDA "Flawed Assets" Clause in Perspective

The decision of the New South Wales Supreme Court in *Enron Australia v. TXU Electricity Ltd.* [2003] NSWSC 1169 ("*Enron*"), discussed in our September 2004 Derivatives Bulletin ("Australian Court Decision Has Troubling Implications for Netting Under the ISDA Master Agreement"), has generated a number of questions and comments from clients and others. We therefore thought it would be useful to offer a somewhat more detailed discussion of the case and its practical and regulatory implications.

The Facts

The basic facts were simple. Enron Australia ("Enron") and TXU Electricity Ltd. ("TXU") had entered into various electricity swap contracts governed by the 1992 ISDA Master Agreement (the "ISDA Master") and settled any amounts due under the trades by net payments on a weekly basis. The parties had elected the Second Method. Enron had ceased making new contracts with TXU before Enron commenced voluntary insolvency proceedings in December 2001; at that time, the parties had 78 open contracts extending out to December 2005. As the Non-Defaulting Party, TXU therefore had the right but not the obligation, under Section 6(a), to designate an Early Termination Date in respect of all of the outstanding Transactions. However, terminating the Transactions would have required TXU to make an immediate settlement payment of about A$3.3 million to Enron — the net amount, on a mark-to-market basis, by which TXU was out-of-the-money. Not surprisingly, TXU chose not to exercise its termination right.

What made the situation even worse from the point of view of Enron's liquidator, however, was that TXU had ceased making any further payments under all the outstanding Transactions. Here, too, TXU was perfectly within its rights under the ISDA Master. It relied on Section 2(a)(iii), often referred to as the "flawed asset" or "conditional payment" clause, under which a condition precedent to payment by a counterparty is that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing. Since the commencement of Enron's insolvency proceedings constituted an Event of Default under Section 5(a)(vii), TXU could suspend all further swap payments with impunity.

In the Schedule the parties had included an Additional Termination Event entitling the Defaulting Party to designate an Early Termination Date where the other party refused to make payments to the Defaulting Party based on the flawed asset clause, but this right arose only where the Defaulting Party had satisfied all its payment or delivery obligations with respect to all outstanding Transactions and had no future payment or delivery obligations to the Non-Defaulting Party under Section 2(a)(i). Because under the open trades (all of them involving bilateral payments), Enron still potentially had future payment obligations to TXU, the Court accepted the argument that Enron would not have the right to designate an Early Termination Date until the expiry of the last outstanding Transaction. Accordingly, the Additional Termination Event was of no immediate benefit to Enron.

As a way out of this impasse the liquidator applied to the Court under a provision of the Australian *Companies Act 2001* that permits liquidators to "disclaim" contracts with the leave of the Court, even ones that are not onerous, on such terms and conditions as the Court sees fit. Simply disclaiming the Transactions without more would not have helped Enron's creditors, since so doing would have terminated the Transactions without entitling Enron to recover the net mark-to-market value of the contracts, except for payments that had fallen due before December 2001.

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Accordingly, the liquidator sought an order that TXU determine the early termination payment as if it had designated an Early Termination Date and then pay the Settlement Amount so determined if it turned out to be a negative number (which would almost certainly be the case). In effect, the liquidator asked the Court to accelerate termination of the contracts by compelling TXU to designate an Early Termination Date. This the Court refused to do. It found that the relevant statutory provision did not "entitle the Court to vary contractual rights and liabilities more or less at large, subject only to discretionary considerations". So doing would deprive TXU of its contractual rights "under contracts which expressly contemplate and deal with the consequences of liquidation, to decline to trigger early termination, and of the benefits they would derive from that course". As a result, the Court found that liquidator would have to wait until all the individual Transactions expired in order to access the amounts owing by TXU. TXU's obligation to pay was not extinguished; it was merely postponed or "suspended". Once the Transactions had expired Enron could designate an Early Termination Date under the Additional Termination Event and so collect the Unpaid Amounts that TXU had refused to pay.

Assessing the Implications of *Enron*

Enron has highlighted two sets of concerns. First, it unexpectedly illustrated how the flawed asset clause in the ISDA Master could in some circumstances operate like a walkaway clause, insulating a Non-Defaulting Party from liability to a Defaulting Party where the parties have not elected Automatic Early Termination and the Non-Defaulting Party is not otherwise required (or the Defaulting Party is not entitled) to designate an Early Termination Date. Second, if this fact situation were to arise where one of the counterparties is a regulated financial institution required to maintain minimum regulatory capital, the decision could be regarded as casting doubt on one assumption that may underlie some bank regulators' willingness to permit financial institutions to net their exposure under derivatives contracts for regulatory purposes — namely, that the amount of that net exposure (calculated on a mark-to-market basis) would ordinarily be payable by or to a defaulting counterparty upon its bankruptcy, liquidation or other default.

However, it is important to keep *Enron* in perspective and not exaggerate its potential impact either on the law of derivatives or their regulatory treatment.

Limited Relevance to Canada and No New Law

First, one must keep in mind the limited statutory context in which *Enron* was decided. Canada's federal insolvency legislation does not authorize a trustee in bankruptcy, CCAA monitor or liquidator to "disclaim" contracts, whether with leave of the court or otherwise, without incurring liability for breach of contract. The particular insolvency issue that faced the court in *Enron* simply could not arise in Canada on these facts. Even with the broad judicial discretion conferred in CCAA proceedings, it would be virtually unprecedented for a judge to make an order overriding clear contractual provisions and thereby extinguishing the vested rights of a third party.

Second, outside the Australian insolvency context, this decision marks no new departure in the law. It simply asserts that the provisions of the ISDA Master, as supplemented in the Schedule, are enforceable in accordance with their terms. The case upholds freedom of contract, a cardinal feature of the ISDA architecture, and holds the parties to their negotiated bargain. As with any freely negotiated contract, the fact that certain provisions have undesirable or unexpected consequences for one party that can be exploited by the other does not give the court jurisdiction to re-write the contract. This result is not surprising, and the fact that the ISDA Master withstood a serious court challenge unscathed should be a cause for celebration in the derivatives market.

The decision has been appealed, but it is difficult to see how the Court's interpretation of the ISDA Master could be faulted.

Regulatory Capital Implications

While it is difficult to predict how bank regulators will respond to the decision, in our view its impact on capital adequacy issues should not be dramatic. The capital adequacy guidelines issued by the Office of the Superintendent of

Financial Institutions ("OSFI") with respect to federally regulated deposit-taking institutions ("DTIs") require that in order for a DTI to account for its exposure under derivatives contracts on a net basis, among other things:

> i. The DTI must have a netting contract or agreement with each counterparty that creates a single legal obligation, covering all included transactions subject to netting. The result of such an arrangement would be that the DTI only has one obligation for payment or one claim to receive funds based on the net sum of the positive and negative mark-to-market values of all of the transactions with that counterparty in the event of default, bankruptcy, liquidation or similar circumstances.
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> ii. The DTI must have written and reasoned legal opinions that, in the event of any legal challenge, the relevant courts and authorities would find the exposure to be the net amount under [applicable law].

These requirements would still be satisfied even where the DTI is party to an ISDA Master that contains the flawed asset clause (as they all do) and the parties have not elected Automatic Early Termination. The agreement still creates a single legal net obligation, with respect to both swap payments and the Settlement Amount payable on early termination, which under Market Quotation is "based on the net sum of the positive and negative mark-to-market values of all of the transactions with that counterparty". The only proviso is that this net amount may not be immediately payable "in the event of default, bankruptcy, liquidation or similar circumstances" if the Non-Defaulting Party elects not to designate an Early Termination Date.

Legal opinions as to the *enforceability* of the netting provisions of the ISDA Master (such as those commissioned by ISDA itself and made available to its members) are also still valid. The ISDA Master is still enforceable in accordance with its terms; and if "exposure" is calculated as the amount payable or receivable on early termination, that exposure would still be the net amount calculated in accordance with the ISDA Master. Some law firms may now wish to include an explanatory note to the effect that the flawed asset clause could postpone an insolvent DTI's ability to enforce payment of the net Settlement Amount if the counterparty elects not to designate an Early Termination Date until and unless the DTI cures its default. We understand that some U.S. firms qualify their ISDA opinions with a statement to the effect that a court may decline to enforce Section 2(a)(iii) of the ISDA Master if the Event of Default relied upon is of a technical or minor nature; but this sort of qualification is not unusual and is probably not a response to *Enron,* where the nature of the default was not in issue. Other firms may decide that no qualification is necessary because the postponement of payment is simply one practical effect of a particular term of the ISDA Master, and ordinarily an opinion that an agreement is "enforceable in accordance with its terms" is generally not expected to explain the effect of those terms.

The other regulatory issue is whether regulators will now regard Section 2(a)(iii) as an impermissible "walkaway clause". OSFI's guidelines contain the following statement:

> Any contract containing a walkaway clause will not be eligible to qualify for netting for the purpose of calculating capital requirements. A walkaway clause is a provision within the contract that permits a non-defaulting counterparty to make only limited payments, or no payments, to the defaulter.

Some commentators have suggested that every ISDA Master now in force is ineligible for netting because the flawed asset clause in effect operates as a walkaway clause. In our view this is at best an overstatement. A true walkaway clause, such as that created by the rarely used First Method, allows the Non-Defaulting Party to avoid making any close-out payment to the Defaulting Party while still remaining entitled to payment. In contrast, the flawed asset clause merely suspends the Non-Defaulting Party's current swap payment obligations to the Defaulting Party and postpones the settlement obligations until termination or cure of the default. Admittedly, if the Defaulting Party is hopelessly insolvent or is in liquidation, curing the default may be impossible; but a counterparty undergoing restructuring or administration could well emerge from insolvency, at which point the Transactions would be restored to good standing and the Non-Defaulting Party would be required to resume payment.

To characterize the flawed asset as a walkaway clause or to generalize its effect also disregards the fact that its relevance to capital adequacy is confined to a relatively narrow set of circumstances — i.e., where a DTI is in default under a derivatives contract and is in a net in-the-money position. Where a defaulting insolvent DTI is out-of-the-money, it is safe to assume that the solvent counterparty will close out its position on or shortly after default so that it can crystallize any unsecured exposure or realize on its collateral. In these circumstances the flawed asset clause is irrelevant because the payor is the Non-Defaulting Party, and the clause expressly does not apply where an Early Termination Date has been designated. It is only the spectre of the reverse situation (which Enron faced) that might conceivably prompt the regulators to consider increasing the risk-weighted credit exposure for an in-the-money swap contract to reflect the risk that in reliance on the flawed asset clause the counterparty will defer or avoid payment of Unpaid Amounts and the mark-to-market Settlement Amount that would otherwise be payable to a failing DTI. However, capital adequacy requirements are not directed solely, or even primarily, towards maximizing the liquidation assets of an insolvent DTI. They are intended mainly to ensure that an otherwise solvent institution holding illiquid and possibly risky assets has sufficient capital to meet the demands of depositors and other creditors on a going concern basis. A solvent DTI could, of course, default under an ISDA Master; but such a default would likely only delay rather than extinguish its right to payment.

It remains to be seen, therefore, whether or how the regulators will recognize or respond to the risks that *Enron* brought to light. We understand that the. Financial Markets Lawyers Group (closely associated with the Federal Reserve Bank of New York) is studying these issues closely and expects to release a report in March 2005, and that the Financial Services Authority in the U.K. is considering the implications of *Enron.* It may be that at the end of the day bank regulators and their counsel will regard the Court's conclusions as unsurprising and requiring no action. The flawed asset clause is nothing new: it has been present in the ISDA Master since 1987, and its effects may well already have been canvassed. How quickly bank regulators will respond to *Enron*, if at all, is also difficult to predict. The nearly finalized Basel II capital accord, which OSFI will no doubt follow in amending its own capital adequacy guidelines, has been over five years in the making. The architects of Basel II may have little appetite for introducing a new substantive issue at this late stage.

Practical Implications and Open Issues

Enron does raise some practical concerns and leaves some questions unanswered.

As a practical matter, counterparties may want to reconsider the common practice of never electing Automatic Early Termination. Usually the loss of control over when termination occurs has been thought to outweigh the marginal benefits to a Non-Defaulting Party of electing Automatic Early Termination. The conventional wisdom is that there are few if any advantages to a Non-Defaulting Party in having the ISDA Master terminate automatically on the insolvency of the other counterparty because under federal Canadian insolvency law derivative contracts may be terminated and closed out notwithstanding statutory and judicial stays that prevent the exercise of such rights for other contracts. However, *Enron* illustrates how Automatic Early Termination could benefit the *Defaulting* Party. If both TXU and Enron had elected Automatic Early Termination, Enron's insolvency would have triggered an Early Termination Date that would have entitled Enron to collect the Unpaid Amounts and the Settlement Amount notwithstanding the flawed asset clause. Of course since counterparties can never predict whether they will be the Defaulting or Non-Defaulting Party, corporate treasurers may still decide that the risks of Automatic Early Termination still outweigh the benefits.

One troublesome issue is whether the Court was correct in accepting the plaintiff's position that under the Additional Termination Event that gave Enron the right to designate an Early Termination Date once it had no further payment or delivery obligations, Enron would eventually be able to exercise that right and thereby trigger TXU's obligation to pay the accrued Unpaid Amounts once all the open contracts had expired. One might question whether either party would have the right to designate an Early Termination Date where all the Transactions had already terminated. It is true that "Early Termination Date" is not defined as the date on which a Transaction is terminated prior to its expiry

date: it is defined functionally simply as "the date determined in accordance with Section 6(a) or 6(b)(iv)". Those sections actually deal not with "termination" (despite the headings) but with the designation of a date referred to as the "Early Termination Date". Therefore one might argue that a counterparty could designate an "Early Termination Date" for an ISDA Master even after all the Transactions had expired.

The problem with this argument is that technically, the amounts payable after designation of an Early Termination Event (including the "Unpaid Amounts") are all referable to "Terminated Transactions", not the ISDA Master itself, and "Terminated Transactions" is defined as the relevant Transactions "*in effect* immediately before the effectiveness of the notice designating that Early Termination Date". It follows, therefore, that if no Transactions are in effect when the notice of designation of the Early Termination Date takes effect (as would be the case with the Enron Additional Termination Event), the designation would be meaningless, because the consequences of the designation could only be determined by reference to Transactions in effect when the notice took effect. Enron would therefore be unable to designate an Early Termination Date until all the Transactions had expired, but at that point, ironically, it would be unable to designate an Early Termination Date *because* all the Transactions had expired! The very event that would entitle Enron to exercise its rights under the Additional Termination Event would render that exercise ineffective.

It may be that a court faced with this harsh paradox might strive to give some effect to the Additional Termination Event by allowing it to apply to expired Transactions and thereby allow the liquidator to recover the accrued Unpaid Amounts, even though strict logic would dictate otherwise. The termination amount payable by TXU under Section 6(e)(ii) would then simply be the aggregate of these Unpaid Amounts (since the mark-to-market value of the expired swaps calculated under Market Quotation would presumably be zero). However, if *Enron* stands for anything, it is that a court must respect the terms of the ISDA Master as written. And those terms simply give no meaning to the designation of an Early Termination Date in respect of Transactions that are no longer in effect.

On a strict reading of the ISDA Master, would a counterparty in Enron's position *ever* be able to recover its Unpaid Amounts if it never emerged from insolvency? Possibly not. In general, at common law the termination or expiry of a contract does not itself extinguish the rights of the parties to enforce payment obligations accrued while the contract was in force. For example, absent clear terms to the contrary, a terminated salesperson would still have the right to collect unpaid commissions earned while her contract was in effect. Likewise one might expect that even without being able to designate an Early Termination Date Enron would still be able to collect Unpaid Amounts that had accrued up to the time the last open trade expired. The difficulty, however, is that the expiry of all the outstanding Transactions does not necessarily terminate the ISDA Master itself. Under Section 1(c), the ISDA Master and all Confirmations form a single agreement. Therefore, even after all the Transactions have expired, the ISDA Master is still in effect. If the agreement is still in effect, the "flawed asset" condition still applies, and so long as Enron remains insolvent, no Unpaid Amounts would be payable. TXU's "suspended" obligation to pay the Unpaid Amounts would therefore remain suspended for all time.

One might argue that as with any contract of indefinite duration, the ISDA Master should be terminable on reasonable notice to the other party, even absent designation of an Early Termination Date. However, given the elaborate termination provisions contained in the ISDA Master, a court might well find such an extra-contractual termination to be ineffective. If a counterparty could terminate an ISDA Master on reasonable notice, without regard to designation of an Early Termination Date, the practice could also cause chaos in the swap markets: in principle a net out-of-the money counterparty could terminate its Transactions, pay the accrued Unpaid Amounts and avoid paying the (probably much larger) Settlement Amount calculated by reference to the mark-to-market value of the contracts.

Accordingly, counterparties may want to consider negotiating an Additional Termination Event that permits the Defaulting Party to designate an Early Termination Date, even if it may have future payment obligations under outstanding Transactions, where the Non-Defaulting Party refuses to make further payments in reliance on Section 2(a)(iii). This of course would largely negate the benefit of the clause to an out-of-the-money Non-Defaulting Party, but it would also prevent what many would regard as an undeserved windfall.

Conclusion

Enron does disclose some gaps in the ISDA architecture (which incidentally persist in the 2002 ISDA Master Agreement, where the flawed asset clause remains unchanged). However, the decision should not spell the end to netting for regulatory capital purposes, nor does it undermine the enforceability of close-out netting in general. It does suggest that counterparties may want to consider plugging some of the gaps with appropriate drafting, but this is as it should be for a document that must evolve to meet the changing needs of the marketplace.

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