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AUSTRALIAN INSOLVENCY LAW AND THE 1992 ISDA MASTER AGREEMENT—CATALYST, REACTION, AND SOLUTION

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Abstract: The reverberations of Enron's financial collapse were heard on an international scale. Indeed, Enron Australia's liquidation set off a flood of concern and speculation about the International Swaps and Derivatives Association's ("ISDA") model documentation for derivative transactions. A December 2003 opinion of the Supreme Court of New South Wales exposed a flaw in the ISDA 1992 Master Agreement. Two provisions of the agreement operate in tandem, creating a result which operates contrary to the clear meaning of the terms. This volatile interaction of the provisions effectively shifts the risk from the parties to the swap contract to the creditors of the defaulting party. This unexpected result poses a real concern for the creditors of parties to swap or derivative instruments governed by the 1992 Master Agreement. The ISDA has articulated policy goals to maintain market stability and efficiency. As the drafter of the model agreements, the ISDA has an ethical obligation to ensure that the terms of the agreement operate according to their clear meaning. Otherwise, the parties can best address the Agreement's deficiencies by taking notice and contracting around them.

I. INTRODUCTION

In December 2003, the Supreme Court of New South Wales, Australia, decided a case involving the rights of an insolvent party under an electricity swap contract.¹ The court held in that case, *Enron Australia Finance Pty Ltd v. TXU Electricity Ltd*, that it did not have authority under Australian insolvency law² to alter the terms of the swap contract to force the non-insolvent party, TXU Electricity ("TXU"), to pay the net amount

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¹ *Enron Austral. Fin. Pty Ltd (in liq.) v. TXU Elec. Ltd* (2003) 48 A.C.S.R. 266 (N.S.W.). An electricity swap contract is an agreement between two parties where one party agrees to pay the market rate and the other agrees to pay a fixed rate over the period of the agreement. Periodically, as agreed to by the parties, the difference between the market rate and the fixed rate is paid to the party owed. See INT'L SWAPS AND DERIVATIVES ASS'N, PRODUCT DESCRIPTIONS AND FREQUENTLY ASKED QUESTIONS, <http://www.isda.org/educat/faqs.html>. Parties generally enter into a number of such agreements, or "confirmations," under the overarching non-economic terms of the Master Agreement. See *infra* Part II.

² Australian insolvency law with respect to corporations is codified in Chapter Five of the Corporations Act, 2001. Corporations Act, 2001, ch. 5.

owed in the event that TXU chose to terminate the agreement.³ The New South Wales Court of Appeal affirmed the lower court's decision in full.⁴

Under the court's interpretation of Australian corporate insolvency law,⁵ the International Swap and Derivative Association's ("ISDA") 1992 Master Agreement ("Master Agreement")⁶ effectively allows TXU to walk away from the contract,⁷ despite the fact that the parties elected a provision that disallows them to walk away from their obligation.⁸ The outcome of the case exposed terms in the Master Agreement that interact to operate contrary to the plain meaning.⁹ The risk of loss that TXU assumed under the Master Agreement was transferred to the creditors of Enron Australia in liquidation, depriving them of the value from the Master Agreement and relieving TXU of any potential payment obligation.¹⁰ In order to reduce the potential for systemic collapse, give effect to the Master Agreement's terms as written, and remain consistent with the ISDA's underlying policy goals, there must be some mechanism to provide for the Master Agreement's termination.¹¹

Those involved in derivatives markets in which courts can determine the enforceability of contractual provisions under insolvency and bankruptcy laws¹² have noticed the *Enron Australia* decision.¹³ This case is significant

³ *Enron Austrl.* (2003) 48 A.C.S.R. 266, para. 77. For an explanation of close-out netting, see *infra* Part II.A.

⁴ *Enron Austrl. Fin. Pty Ltd (in liq.) v. TXU Elec. Ltd.*, (2005) N.S.W.C.A. 12.

⁵ See *infra* Part IV.

⁶ International Swaps and Derivatives Association, 1992 Master Agreement (Multicurrency – Cross Border) [hereinafter 1992 Agreement]; see discussion of the ISDA's background *infra* Part II.

⁷ Gary Walker & Guy Usher, *Good Law—Serious Implications: Enron Australia v. TXU Electricity*, 19 J. INT'L BANKING L. & REG. 414, 415 (2004); see *infra* Part IV.

⁸ By selecting the Second Method, and not selecting the First Method, both parties implicitly agreed that walking away would not be an option for the defaulting parties; see discussion *infra* Part V.B.

⁹ See *infra* Part V.B.

¹⁰ See *infra* Part IV.C.

¹¹ See *infra* Part V.B.

¹² Courts that traditionally have the power to determine and alter the enforceability of contracts in the event of insolvency are located within countries with historic ties to English bankruptcy law, including England, Canada, New Zealand, and the United States.

¹³ See, e.g., *Bad News for Insolvent Counterparties – 1½ Way Payments Under ISDA Master Agreement?*, ALLENS ARTHUR ROBINSON, FOCUS: BANKING AND FIN., Feb. 2004, available at <http://www.aar.com.au/pubs/baf/fobaffeb04.htm> [hereinafter AAR] (discussing the consequences of the case from an Australian perspective); Robert Scavone et al., *Some Further Thoughts on Enron Australia v. TXU: Putting the ISDA "Flawed Assets" Clause in Perspective*, MCMILLAN BINCH, DERIVATIVES BULL., Dec. 2004, available at <http://www.mcmillanbinch.com/Upload/Publication/enron%20v%20australia%201204.pdf> [hereinafter MCMILLAN BINCH] (discussing the potential outcome and significance of the case under Canadian Law); Jeremy D. Weinstein, et al., *Escape From the Island of the One-Way Termination: Expectations and Enron v. TXU*, FUTURES & DERIVATIVES L. REP., Nov. 2004, at 1 (discussing the potential outcome and significance of the decision under the U.S. Bankruptcy Code); Jeremy Carter, *FSA Asks Bank of England to Review Aussie Ruling*, DERIVATIVES WEEK, July 23, 2004, available at <http://www.derivativesweek.com/default.asp?page=1&SID=424923&ISS=10644> (noting the

because end users of varying sophistication enter into derivative contracts both for hedging and investing purposes.¹⁴ Additionally, there is a growing concern regarding the obligations of private entities that draft model transactional documents.¹⁵ The Master Agreement's subversive operation is also inconsistent with the accounting and disclosure of swap and derivative transactions.¹⁶

While reactions have been varied,¹⁷ the case highlighted a potentially unanticipated outcome under the ISDA Master Agreement; one that leaves an aftertaste of inequity. In the interests of maintaining market stability and the transparency of risk allocation among parties to swap contracts governed by the Master Agreement, the ISDA should amend the agreement to allow for its timely termination in the event of one party's liquidation. The ISDA has an interest, and perhaps even an obligation, to ensure that the default outcome under the Master Agreement is clear from the express language and terms, and to protect the derivative instrument as an asset in a defaulting party's liquidation.

This Comment argues that the ISDA has assumed a role of responsibility for the stability of the over-the-counter ("OTC") derivatives market. It is likewise in the interest of this privately regulated multinational industry to maintain market stability through the clear operation of the terms of the Master Agreement. The ISDA thus has both an obligation to amend, and interest in amending, the model documentation to provide for clear operation of the model agreements. Part II provides background to the ISDA and select provisions of the 1992 Master Agreement. Part III briefly explains a debtor's contractual rights under Australian insolvency law. Part IV examines the *Enron Australia* opinion and the inequitable risk transfer under the Master Agreement from the non-defaulting party to the defaulting party's creditors. Part V examines the potential effects of, and issues raised

potential and serious implications of the *Enron Australia* decision, and the impact on English regulatory law).

¹⁴ See, e.g., Adam R. Waldman, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance Into the Abyss?*, 43 AM. U. L. REV. 1023, 1035 (1994) (noting that even school districts are utilizing derivatives in an effort to control financial risk); William J. Bergman et al., *Netting, Financial Contracts, and Banks: The Economic Implications* 30 (Aug. 12, 2003) (unpublished manuscript, FRB of Chicago Working Paper No. 2004-02), available at <http://www.chicagofed.org/publications/workingpapers/wp2004-02.pdf> (discussing the use of credit derivatives by financial institutions).

¹⁵ See *infra* Part V.

¹⁶ See *infra* Part V.B.

¹⁷ Compare Carter, *supra* note 13 (noting that the Bank of England's Financial Markets Law Committee was reviewing the impact of the *Enron Australia* decision on regulation of capital netting for regulated financial institutions), with Weinstein et al., *supra* note 13, at 4 (stating that the outcome of the case "enforced a contract as written in a manner close enough to what must have been intended").

by, this decision in comparison with the underlying purpose of the ISDA Master Agreement. Part VI argues that derivative market participants should be made aware of the operation of the Master Agreement in the event of the insolvency of an in-the-money party in order to contract around the outcome demonstrated in *Enron Australia*. The ISDA, however, is best suited, and perhaps obligated, to resolve any undesired outcomes under the Master Agreement.

II. THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION MAINTAINS MARKET STABILITY THROUGH PRIVATE REGULATION

The ISDA is a private international regulatory corporation which drafts model contracts, lobbies local governments for correct rules, and works to maintain market stability.¹⁸ In 1992, it created the 1992 ISDA Master Agreement, a model agreement for parties entering into multiple OTC derivative transactions.¹⁹ The Master Agreement allows the parties to engage in a series of less-formal transactions under the Master Agreement's overarching terms.²⁰ The Master Agreement sets forth all of the non-economic terms of such transactions²¹ in order to increase the parties' ability to efficiently enter into swap transactions by merely setting the economic terms, such as the price, amount, and period for each individual transaction.²²

The following is a brief introduction to four key concepts and provisions within the 1992 Master Agreement relevant to the ISDA's regulatory ability, as it applies to the *Enron Australia* decision and this

¹⁸ INT'L SWAPS AND DERIVATIVES ASS'N, ISDA MISSION STATEMENT, <http://www.isda.org/www/mission.html> [hereinafter ISDA Mission]; ALLEN & OVERY, AN INTRODUCTION TO THE DOCUMENTATION OF OTC DERIVATIVES: "TEN THEMES" 2 (May 2002) [hereinafter TEN THEMES], http://www.isda.org/educat/pdf/documentation_of_derivatives.pdf. See ALLEN & OVERY, AN INTRODUCTION TO THE DOCUMENTATION OF OTC DERIVATIVES 2-5 (May 2002), for a history of the ISDA generally and the progression of the model instruments thereby developed.

¹⁹ TEN THEMES, *supra* note 18. OTC derivative transactions allow parties to more efficiently and easily enter into transactions to meet the changing need to hedge risks in fluctuating commodity markets and expected cash flows. DIETMAR FRANZEN, DESIGN OF MASTER AGREEMENTS FOR OTC DERIVATIVES 17 (2001). Over-the-counter derivatives are financial instruments negotiated by the parties to the instrument, as opposed to listed derivatives available on an exchange. ROBERT A. STRONG, DERIVATIVES: AN INTRODUCTION 5 (2002).

²⁰ TEN THEMES, *supra* note 18, at 1-2. Each separate transaction is recorded in a written instrument known as a confirmation. *Id.* at 2. Each confirmation is made under the Master Agreement and together, they are said to constitute a single agreement, all incorporated into the Master Agreement itself. 1992 Agreement, *supra* note 6, § 1(c).

²¹ FRANZEN, *supra* note 19, at 19; *see, e.g.*, 1992 Agreement, *supra* note 6 (including procedures, legal terms, definitions, default conditions, etc.).

²² TEN THEMES, *supra* note 18, at 2.

Comment. These concepts are essential to understanding how the terms of the 1992 Master Agreement interact, and the variety of potential outcomes in the event of one party's insolvency. First, netting requirements are imperative to determining each party's risk when entering into each individual transaction under the Master Agreement. This is also significant to the outside creditors of the contracting parties.²³ Next, the Master Agreement specifies several events of default, which have two major implications: the non-defaulting party's option to declare an early termination date,²⁴ and a stay of the non-defaulting party's payment obligations under the Agreement²⁵ (also known as the "flawed-asset provision").²⁶ The parties may also include additional termination events that allow the parties to adapt the Master Agreement to the local jurisdictional laws, or to temper the consequences to an insolvent party under the Master Agreement.²⁷

A. *Netting*

Netting is a key concept within both the ISDA and international markets as a whole.²⁸ The Master Agreement's netting provision allows each of the individual transactions entered into under the agreement to be treated as a single transaction.²⁹ At the time payments are periodically due,³⁰ the netting provision offsets the amounts payable by each party, creating a net amount payable.³¹ A significant consequence of parties' ability to net transactions arises when one of the parties has become insolvent.³² Without

²³ See *infra* Part II.A.

²⁴ See *infra* Part. II.B. (discussing the right of the non-defaulting party to close out all outstanding transactions upon the default of the counterparty).

²⁵ See *infra* Part II.C. (explaining that as the periodic settling dates for the individual transactions come due, the non-defaulting party's obligations are stayed due to the existing event of default, also referred).

²⁶ 1992 Agreement, *supra* note 6, § 2(a)(iii).

²⁷ See 1992 Agreement, *supra* note 6, § 5(b)(v); discussion *infra* Part II.D.

²⁸ See TEN THEMES, *supra* note 18, at 4.

²⁹ 1992 Agreement, *supra* note 6, § 1(c).

³⁰ On dates periodically specified by the parties, or as mentioned in the individual confirmations, the amounts owed to each party are netted together, to create one amount payable by the party that is net "out-of-the-money" to the party that is net "in-the-money." See ROBERT W. KOLB, FUTURES, OPTIONS, AND SWAPS 702-03 (4th ED. 2003); TEN THEMES, *supra* note 18, at 4.

³¹ 1992 Agreement, *supra* note 6, § 2(c) (stating that the parties may elect to net the aggregate amounts payable by each respective party across multiple transactions).

³² See TEN THEMES, *supra* note 18, at 4. Insolvency for the purpose of this statement means when the counterparty is unable to pay the amount owed in a given transaction under the Agreement. Australian law defines insolvency as the inability to pay debts as they become due. Corporations Act, 2001, pt.1.2, div. 7, § 95A; see JOHN DUNS, INSOLVENCY LAW AND POLICY 80-82 (Trischa Baker ed., 2002).

an enforceable netting provision, an insolvent party attempts to collect the amount owed to it from the non-defaulting party under one derivative transaction. The insolvent party is simultaneously unable to pay its obligation to the non-defaulting party under another transaction.³³ A party's financial risk is decreased by allowing the financial obligations under the Master Agreement to be netted.³⁴ Potential creditors consequently are willing to provide credit on more favorable terms.³⁵ Because netting allows swaps to have smaller sums at risk, it permits a party entering into the agreement to adjust the risk exposure by smaller increments when entering into additional transactions.³⁶

The systemic implications of netting are particularly apparent in the event of insolvency.³⁷ Companies within a particular industry are often engaged in a web of interrelated swap and derivative agreements.³⁸ The lack of a netting provision may create a chain reaction of recognized losses, leading ultimately to systemic collapse of the particular market.³⁹ The ISDA has been particularly successful in obtaining legal opinions that affirm

³³ The attempt to collect amounts owed while avoiding payment of amounts owed to the counterparty is referred to as "cherry-picking." TEN THEMES, *supra* note 18, at 4. While helping to maximize the amount of funds available to pay the bankrupt party's creditors, such "cherry-picking" increases the risk of each party in the event of the other's insolvency. *See id.*; Waldman, *supra* note 14, at 1059.

³⁴ Close-out netting refers to the amount paid upon termination of all of the transactions under the agreement, usually as a result of bankruptcy, insolvency, or another event of default. *See* discussion *infra* Part II.B. The ISDA defines close-out netting as the combination of the credit exposure of each party to the agreement into one amount payable by the party that is net in-the-money. INT'L SWAPS AND DERIVATIVES ASS'N, PRODUCT DESCRIPTIONS AND FREQUENTLY ASKED QUESTIONS NO. 30, <http://www.isda.org/educat/faqs.html>.

³⁵ *See* TEN THEMES, *supra* note 18, at 4. Netting reduces the amount a party can lose in the event the counterparty fails to make the expected payment. This increases the credit-worthiness of the party and makes credit less expensive, because the credit provider's exposure is lessened when extending credit to the party.

³⁶ *See* STRONG, *supra* note 19, at 319-20 (explaining that the amount at risk to a swap agreement is in line with the net periodic payments made between parties, and not the entire payments to be made).

³⁷ Thomas J. Werlen & Sean M. Flanagan, *The 2002 Model Netting Act: A Solution For Insolvency Uncertainty*, BUTTERWORTHS J. INT'L BANKING & FIN. L., Apr. 2002, at 154, 155-56.

³⁸ *See, e.g., id.*, at 156 (discussing the reduction of risk that netting provides to the banking and finance industry, which commonly has participants in a web of credit derivatives).

³⁹ *See* Bergman, *supra* note 14, at 30 (recognizing that close-out netting is an effective method of reducing systemic risk). In terms of regulated financial institutions, the reduction of systemic risk has been recognized as a justification for the right to close-out netting in the United States since the early twentieth century. *See id.*, at 11 (citing *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528 (1913)). *But see* Robert R. Bliss & George C. Kaufman, *Derivatives and Systemic Risk: Netting, Collateral, and Closeout* (Apr. 8, 2005) (unpublished manuscript), http://www.chicagofed.org/economic_research_and_data/files/sem_bliss_kaufman.pdf (arguing that it is not clear whether netting results in a reduction of systemic risk). The gross amounts at risk can be much larger than the net exposure, thus creating an important reliance on ability to offset amounts owed when the purpose of entering into such agreements is to accurately hedge risks. Werlen & Flanagan, *supra* note 37, at 154.

the netting provision's enforceability in credit derivative instruments under the Master Agreement.⁴⁰ It has also effectively lobbied jurisdictions to pass statutory laws upholding contractual netting rights in the event of insolvency.⁴¹ The Master Agreement would have little practical effect as a useful risk management tool if the netting provisions were not recognized in the relevant jurisdiction.⁴²

B. *Events of Default and Early Termination*

The Master Agreement specifically lists events which will result in the default of a party to the agreement,⁴³ including circumstances beyond traditional notions of contract breach.⁴⁴ For example, section 5(a)(vii) of the Master Agreement dictates that an event of bankruptcy will result in default.⁴⁵

A defaulting party does not necessarily implicate termination of the Master Agreement.⁴⁶ A transaction that terminates prior to the natural expiration date—as contracted for in each individual transaction—due to an event of default or otherwise, is only subject to an early termination date.⁴⁷ The non-defaulting party may choose whether and when to set an early termination date.⁴⁸ If the parties elect an automatic termination date upon

⁴⁰ Werlen & Flanagan, *supra* note 37, at 157. Credit derivative contracts follow the same basic ISDA Master Agreement structure, and are thus relevant to the present discussion. See Bergman, *supra* note 14.

⁴¹ See Werlen & Flanagan, *supra* note 37, at 157. The ISDA's model legislation is not limited to the credit derivative market, and aims to uphold all contractual netting provisions in an effort to maintain market stability. Int'l Swaps and Derivatives Ass'n, 2002 Model Netting Act, pt.1, § 4.

⁴² Tamasin Little, *Regulation by Non-Regulators*, in ISSUES IN DERIVATIVE INSTRUMENTS 27, 34 (Edward J. Swan ed., 1999).

⁴³ 1992 Agreement, *supra* note 6, § 5(a).

⁴⁴ See, e.g., *id.* §§ 5(a)(iii)–(viii) (including merger without assumption of all obligations, and an event of bankruptcy, in addition to material misrepresentations).

⁴⁵ *Id.* § 5(a)(vii) (also including, for example, becoming insolvent, having an administrator appointed, or a company becoming subject to an order of liquidation). For the purposes of this comment, the discussion of events of default will be assumed to fall under an event of bankruptcy, as enumerated in section 5(A)(vii) of the 1992 Master Agreement, particularly (5), there under, which states, “has a resolution passed for its winding-up. . . or liquidation (other than pursuant to a consolidation, amalgamation or merger)[.]” *Id.* § (5).

⁴⁶ See *id.* § 6(a) (indicating that upon a continuing event of default, the non-defaulting party then has a right to terminate the Agreement). This right or option to terminate may be subjected to limitation by the parties to the contract. See *id.*; Int'l Swaps and Derivatives Ass'n, Schedule to the 1992 Master Agreement, pt. I(e) [hereinafter 1992 Schedule] (allowing for parties to elect for an automatic termination upon selected “events of bankruptcy,” as defined in Section 5(a)(vii) of the 1992 Agreement).

⁴⁷ *Id.* § 6(a) (indicating that an “early termination date” includes termination following an event of default).

⁴⁸ Enron Austl. Fin. Pty Ltd (in liq.) v. TXU Elec. Ltd (2003) 48 A.C.S.R. 266, para. 19.

the specifically enumerated events of default due to bankruptcy,⁴⁹ the non-defaulting party does not have a right to elect termination of the transactions, as this option ends the transactions automatically.⁵⁰

The non-defaulting party considers a number of factors when determining when and whether to elect an early termination date.⁵¹ If the non-defaulting party is risk-averse, or changes in the market affect their position adversely, the non-defaulting party would declare the termination date as soon as possible to avoid any loss in position.⁵² Alternatively, the non-defaulting party may choose not to declare an early termination date if they are willing to risk that the market may move favorably in their direction.⁵³ In the event that the defaulting party is owed money by the non-defaulting party, it may be in the best interests of the non-defaulting party not to declare an early termination date at all.⁵⁴ Thus, more important than the right to set an early termination date is the right *not* to.⁵⁵

Parties to the Master Agreement have two main options for designating an early termination date in the event of default⁵⁶ as provided in the Model Agreement: First Method and Second Method.⁵⁷ The First Method allows a non-defaulting party to collect payment in the event they

⁴⁹ 1992 Agreement, *supra* note 6, § 6(a) (setting forth the default events that may give rise to an automatic termination).

⁵⁰ See *id.*, as elected by the parties in the Schedule. 1992 Schedule, *supra* note 46, pt. I(e). For a further discussion of the automatic termination date, see *infra* Part VI.B.

⁵¹ See Weinstein et al., *supra* note 13, at 3.

⁵² See FRANZEN, *supra* note 19, at 23. The declaration of the termination event solidifies the party's economic gain or loss. If it is a gain for the non-defaulting party it is submitted as a claim to the liquidation of the defaulting party. In the event that the solidified amount is a loss to the non-defaulting party, then payment is subject to the method elected. See Bergman, *supra* note 14, at 16-17 (regarding the insolvency of financial institutions); see also *infra* notes 64-69 and accompanying text.

⁵³ MCMILLAN BINCH, *supra* note 13, at 4-5. If successful, a party could increase the amount of their claim or decrease their liability to the defaulting party. *Id.*

⁵⁴ This was the decision made by TXU in the case of Enron Australia's event of default. See discussion *infra* Part IV; *Enron Austl.* (2003) 48 A.C.S.R. 266, para. 19.

⁵⁵ See *infra* Part IV. Cf. *Enron Austl.* (2003) 48 A.C.S.R. 266 (concluding that the non-defaulting party indeed does not have to declare an early termination date, and cannot be compelled to do so by the Australian courts).

⁵⁶ 1992 Agreement, *supra* note 6, § 6(a), (e)(i).

⁵⁷ *Id.* § 6(e). There are also two options for the method of determining the amounts owed: "market quotation" and "loss." See *id.* § 14 (defining "loss" and "market quotation"). As these distinctions have little relevance to the present discussion, it is sufficient to note that "loss" is essentially the value of the total loss and costs associated with the termination of the transactions as determined by the good faith efforts of the parties to the agreement, while "market quotation" is the present value of the future transactions that would have been paid based on prices set by principal market participants and market-makers. See *id.*

are in-the-money,⁵⁸ and pay nothing in the event they owe money to the defaulting party.⁵⁹ The First Method is used less frequently,⁶⁰ but its consequences to creditors of the insolvent defaulting party remain important.⁶¹ The Second Method is the purported bilateral netting option, which requires either party to pay the net close-out amount, regardless of which party defaulted.⁶² This method is particularly important with regard to the netting requirement, as it allows a party and its creditors the assurance that payments will be available in the event of liquidation.⁶³

Parties contracting under the Master Agreement have another option regarding the termination of the transactions.⁶⁴ The parties may elect for an early termination date to be set automatically in the event that a party defaults via a particular event of bankruptcy.⁶⁵ This option may avoid any question of whether a non-defaulting party should assume the risk and wait before setting an early termination date. It also provides greater certainty to

⁵⁸ A party to a swap instrument is in-the-money if, in the event of termination of the Agreement, that party would be owed a net payment from the counterparty. This terminology comes from the valuation of options. ROBERT A. STRONG, *DERIVATIVES: AN INTRODUCTION* 29 (2002) (stating that an in-the-money option is defined as an option that has intrinsic value in that upon exercise the value will be higher than the exercise price).

⁵⁹ See 1992 Agreement, *supra* note 6, § 6(e)(i)(1), (3).

⁶⁰ See, e.g., Walker & Usher, *supra* note 7, at 415 (noting that the ISDA 2002 Master Agreement leaves out the First Method as an option). The First Method is not used for regulated financial institutions as the capital adequacy requirements of most jurisdictions, per the Basle Capital Accord, do not allow for a clause that allows a non-defaulting party to walk away from their obligations under the netting agreement. See, e.g., FDIC Statement of Policy on Risk-Based Capital, 12 C.F.R. pt. 325, app. A (II)(E)(5)(b) (1999) (adopting the exact language in the 1994 amendment to the Basle Capital Accord); Australian Prudential Regulation Authority Guidance Note 112.3 (8)(f) (Sept. 2000) (netting agreements for Authorized Deposit taking institutions may only be given effect in the absence of a walkaway clause). This disallowance is in an effort to maintain systemic stability and encourage the efficient use of capital by financial institutions. By not electing the First Method, institutions can theoretically count the amount expected under a netting agreement as an asset in the event of insolvency, thus decreasing requisite capital reserve amounts, and freeing up capital that may be used more productively. Werlen & Flanagan, *supra* note 37, at 156; Basle Committee on Banking Supervision, *The Treatment of the Credit Risk Associated With Certain Off-Balance Sheet Items*, pt. 2, para. 5 (July 1994).

⁶¹ See discussion *infra* Part V.

⁶² 1992 Agreement, *supra* note 6, § 6(e)(i)(3) & (4).

⁶³ See Walker & Usher, *supra* note 7, at 415. The Second Method was actually deemed to be required for this very purpose of assurance via the 1994 amendment to the Basel Capital Accord. See Basle Committee on Banking Supervision, *supra* note 60, pt. II.

⁶⁴ 1992 Agreement, *supra* note 6, § 6(a).

⁶⁵ 1992 Schedule, *supra* note 46, pt. (I)(e). Parties may elect to have the automatic early termination provision apply to either or both parties. *Id.* Particular events of bankruptcy include dissolution of a company, assignment to creditors, winding-up of the company, and the appointment of an administrator or receiver, respectively. 1992 Agreement, *supra* note 6, §§ 5(a)(vii) (1), (3), (5), and (6).

the defaulting party in the event of liquidation and allows for more expedient and efficient winding up⁶⁶ of the liquidating company.⁶⁷

C. *Flawed Asset Provision*

Parties under the Master Agreement are required to make payments periodically as set forth in the confirmations of the individual transactions.⁶⁸ The party's payment obligations are subject to two conditions precedent.⁶⁹ First, there must not be a continuing event of default by the counterparty.⁷⁰ Second, there must be no declaration of an early termination date.⁷¹ Thus, if one party is in default via insolvency or liquidation, then the counterparty's payment obligation is stayed as long as the defaulting condition persists.⁷² A corollary logically follows—a party may cure a position of default, and cause the suspended payment obligation to be revived, so long as an early termination date has not already been set.⁷³

While the mechanics of the flawed asset provision are very straightforward in theory, in practice it is a controversial term.⁷⁴ Some jurisdictions allow parties to avoid such provisions by statute, even voiding the effectiveness entirely.⁷⁵ Traditional freedom of contract arguments assert that it would be unfair to allow an insolvent party to expect performance under a contract when that party is unable to meet its contractual obligations.⁷⁶ When such provisions are upheld as enforceable in the courts, freedom of contract proponents are pleased that parties may rely on the

⁶⁶ "Winding up" is the process by which the assets are sold and creditors are paid in preparation for the dissolution of a business organization. BLACK'S LAW DICTIONARY (8th ed. 2004).

⁶⁷ See *infra* Part VI.B.

⁶⁸ 1992 Agreement, *supra* note 6, § 2 (a)(i).

⁶⁹ *Id.* at § 2 (a)(iii).

⁷⁰ *Id.* at § 2(a)(iii)(1).

⁷¹ *Id.* at § 2(a)(iii)(2).

⁷² See *id.* at §§ 2(a)(iii), 5(a)(vii); *infra* Part IV. See, e.g., *Enron Austral. Fin. Pty Ltd (in liq.) v. TXU Elec. Ltd* (2003) 48 A.C.S.R. 266, para. 12 (Enron Australia's continued insolvency continued to suspend the payment obligation of TXU).

⁷³ See 1992 Agreement, *supra* note 6, § (2)(a)(iii)(1); *Enron Austral.* (2003) 48 A.C.S.R. 266, para. 12.

⁷⁴ See Walker & Usher, *supra* note 7, at 414-15; MCMILLAN BINCH, *supra* note 13, at 1.

⁷⁵ See, e.g., 11 U.S.C. § 365 (2000) (allowing for the cure of defaults conditioned on bankruptcy, and disallowing the alteration of terms, such as suspending performance, of a contract based on bankruptcy proceedings).

⁷⁶ See Walker & Usher, *supra* note 7, at 416. The operation of the flawed asset provision, if given effect by the local jurisdiction, makes sure that the defaulting party derives no benefit from the contract, if it is in fact in default. 1992 Agreement, *supra* note 6, § 2(a)(iii). See generally Alan Schwartz, *Contracting for Bankruptcy Systems*, in THE FALL AND RISE OF FREEDOM OF CONTRACT, 281, 286-87 (proposing that parties should not be restricted from contracting about bankruptcy issues). The United States Bankruptcy Code limits parties' ability to contract about bankruptcy by allowing the debtor to cure default in unexecuted executory contracts if default is based on insolvency or bankruptcy. 11 U.S.C. § 365(e) (2000).

terms contracted for.⁷⁷ An opposing viewpoint sees these provisions as potentially unfair and in conflict with the bankruptcy system.⁷⁸

D. *Additional Termination Events*

Parties to the Master Agreement may elect to designate an additional termination event in the schedule to the agreement.⁷⁹ This allows parties to set forth additional events in the Master Agreement's schedule that result in early termination.⁸⁰ Under the additional termination event provision, a party may negotiate a clause that will give it greater control of ending or liquidating transactions upon the occurrence of a specified event.⁸¹ This clause demonstrates that the Master Agreement is truly a set of default rules that parties can contract around and adapt to their individual preferences subject to the governing jurisdiction's laws.⁸²

III. AUSTRALIAN CORPORATE INSOLVENCY LAW IS MARKED BY A BACKGROUND OF LEGISLATION AND JUDICIAL DISCRETION

A. *Background and Jurisdiction*

The Corporations Act of 2001 currently governs corporate insolvency in Australia.⁸³ General Australian corporations law represents a forty-year movement toward a uniform federal body of law.⁸⁴ The Australian Constitution provides no direct provision for giving federal jurisdiction over corporations law.⁸⁵ In reaction to the uncertainty of a uniform body of law

⁷⁷ See Weinstein et al., *supra* note 17, at 4 n. 13

⁷⁸ See generally Waldman, *supra* note 14 (noting generally that the ISDA Master Agreement has largely been incompatible and in conflict with the United States Bankruptcy Code)

⁷⁹ 1992 Agreement, *supra* note 6, § 5(b)(v); 1992 Schedule, *supra* note 46, pt. 1(h).

⁸⁰ 1992 Agreement, *supra* note 6, § §6(b). Termination events listed in the Agreement itself include an illegality or the imposition of a new tax affecting the parties' transactions. *Id.*

⁸¹ See, e.g., CLAYTON UTZ, ISDA MASTER AGREEMENT: EFFECTIVENESS OF "FLAWED ASSET" CLAUSE – ENRON v. TXU, (March 29, 2005), http://www.claytonutz.com/areas_of_law/controller.asp?aolstring=3&na=797 (discussing the additional termination event listed in the Enron Australia Master Agreement that was originally designed to prevent unfair operation of the flawed asset provision on the buyer of an option); see discussion *infra* Part V.A.

⁸² This raises the question as to whether Enron Australia, as a sophisticated party, should have relied on the terms of the Master Agreement, or whether Enron Australia's counsel failed to sufficiently consider every possible outcome under the terms of the contract. See discussion *infra* Part VI.

⁸³ Corporations Act, 2001, ch. 5 (Austl.).

⁸⁴ See generally DUNS, *supra* note 32, at 4-6 (discussing the move of jurisdiction over corporate law from the states and territories to that of the commonwealth).

⁸⁵ 2-14 COLLIER INTERNATIONAL BUSINESS INSOLVENCY GUIDE, pt. 14.01 (1) (MB) [hereinafter COLLIER INTERNATIONAL]. But see Constitution § 51(xvii) (Austl.) (granting Commonwealth jurisdiction

governing corporations, and in an effort to ground Commonwealth jurisdiction over corporate law in the Australian Constitution, the States and Territories agreed to refer their jurisdiction to the Commonwealth.⁸⁶ The States and Territories referred legislative jurisdiction to the Commonwealth and accepted the Commonwealth Parliament's legislation of the Corporations Act 2001⁸⁷ as the current governing body of law for corporate insolvency in Australia.⁸⁸

Both the federal courts and the state or territory courts preside over corporate insolvency matters,⁸⁹ although state and territory supreme courts resolve most corporate insolvency issues.⁹⁰ Decisions of the Supreme Court Judge sitting alone are appealed to the Supreme Court – Court of Appeal,⁹¹ before being appealed to the High Court of Australia.⁹²

over individual bankruptcy law and proceedings); Constitution § 51(xx) (Austl.) (granting Commonwealth jurisdiction over foreign corporations).

⁸⁶ See Corporations (Commonwealth Powers) Act 2001, § 1(2) (N.S.W.); Explanatory Notes to Corporations (Commonwealth Powers) Bill 2001, 1 (Queensl.). This allowed jurisdiction to be grounded in the Australian Constitution, which allows the Commonwealth Parliament to legislate over areas of law that the States and Territories have referred to the Commonwealth. See Constitution § 51(xxxvii) (Austl.).

⁸⁷ Corporations Act, 2001 (Austl.). Each State and the Northern Territory passed identical legislation referring legislative jurisdiction to the Commonwealth Parliament. See, e.g., Corporations (Commonwealth Powers) Act, 2001 (N.S.W.) (relinquishing jurisdiction of corporate law to the Commonwealth).

⁸⁸ See Corporations Act, 2001, ch. 5 (Austl.). See generally DUNS, *supra* note 32. The Corporations Act of 2001 was essentially substantively identical to the Corporations Act of 1989, except the former had constitutional grounds for jurisdictional authority. *Id.*; see Corporations Act of 2001, ch. 1, pt.1.1, § 3 (Austl.) (basing jurisdiction on the referral of jurisdiction by the States and Territories, pursuant to paragraph 51(xxxvii) of the Australian Constitution).

⁸⁹ See Corporations Act, 2001, ch. 9, pt. 9.6A, div. 1, § 1337B.

⁹⁰ See COLLIER INTERNATIONAL, *supra* note 85, pt. 14.03(1). The State and Territory Supreme Courts are the highest courts in the States and Northern Territory. However, this system is not as linear of a judicial hierarchy as in the United States. See generally Mary Crock & Ronald McCallum, *Australia's Courts: Their Origins, Structure and Jurisdiction*, 46 S.C. L. REV. 719 (1995) (noting that unlike in the United States, the Australian Commonwealth originally vested federal jurisdiction upon the lower state courts until the 1960s). Civil cases in New South Wales involving amounts greater than \$750,000 have original jurisdiction in the Supreme Court. See N.S.W. DEP'T EDUC. & TRAINING, THE STRUCTURE OF THE NEW SOUTH WALES COURT SYSTEM, at <http://www.schools.nsw.edu.au/sites/nswconstitution/html/5th/bgr/overview.html> [hereinafter COURT STRUCTURE].

⁹¹ Appeals from a decision by the Supreme Court are seen by a panel of three Supreme Court Judges. COURT STRUCTURE, *supra* note 90.

⁹² *Id.* The High Court of Australia only hears cases by granting of petition to the Court. Crock & McCallum, *supra* note 90, at 733.

B. *Voluntary Administration and Winding Up*

Australian law provides alternatives to immediate liquidation for a corporation in financial trouble.⁹³ Corporations typically favor voluntary administration proceedings,⁹⁴ because the courts are not involved in the initial stages of administration.⁹⁵ Appointing an administrator allows a struggling company the best chance to continue its existence by emerging from or avoiding insolvency.⁹⁶ In order to enter into voluntary administration, a company must officially determine that it is either insolvent or is likely to become insolvent,⁹⁷ and that it needs the aid of an administrator.⁹⁸

Once a company is in voluntary administration, there are two phases.⁹⁹ First, the administrator takes control of the company and its affairs,¹⁰⁰ acts as the company's agent,¹⁰¹ and investigates what future plan for the company will be in the creditors' best interests.¹⁰² Second, within twenty-one days of the beginning of the administration,¹⁰³ the administrator convenes a meeting of the creditors to determine whether the company

⁹³ See, e.g., Corporations Act, 2001, ch. 5, pt. 5.3A (voluntary administration). Other jurisdictions have similar alternatives to liquidation in an attempt to financially revive a corporation. See, e.g., 11 U.S.C. ch. 11 (business reorganizations); see also AUSTL. L. REFORM COMM'N, REP. NO. 45: GENERAL INSOLVENCY INQUIRY, CH. 3 (Dec. 1988) (considering the merits of other jurisdictions' alternatives to liquidation) [hereinafter Harmer Report]. The liquidation of a company under the Australian corporation law is referred to as winding up. See Corporations Act, 2001, ch. 5, pt. 5.6 (Austl.).

⁹⁴ See COLLIER INTERNATIONAL, *supra* note 85, pt. 14.06(1).

⁹⁵ See *id.*; DUNS, *supra* note 32, at 449-50. The other alternative to liquidation for corporations under Australian insolvency law is a Scheme of Arrangement, where the debtor company enters into a court-approved restructured set of agreements with its creditors in order to remain solvent. Corporations Act, 2001, ch. 5, pt. 5.1 (Austl.).

⁹⁶ Corporations Act, 2001, ch. 5, pt. 5.3A, § 435A (Austl.).

⁹⁷ Insolvency under the Corporations Act of 2001 is defined as the inability to pay debts as they become due. Corporations Act, 2001, ch. 1, pt. 1.2, div. 7, § 95A (Austl.); see also Paul B. Lewis, *Trouble Down Under: Some Thoughts on the Australian-American Corporate Bankruptcy Divide*, 2001 UTAH L. REV. 189, 191-92 (discussing the process of Voluntary Administration in more detail).

⁹⁸ Corporations Act, 2001, ch. 5, pt. 5.3A, § 436A (Austl.); see also DUNS, *supra* note 32, at 449-50 (noting the fairly simple process by which an administrator is selected and Voluntary Administration begins).

⁹⁹ Lewis, *supra* note 97, at 192-93.

¹⁰⁰ Corporations Act, 2001, ch. 5, pt. 5.3A, div. 3, § 437A (Austl.).

¹⁰¹ *Id.* § 437B.

¹⁰² *Id.* div. 4, § 438A. The administrator is charged with determining whether it would be in the creditor's interests for the company to form a plan of arrangement, for the administration to end, or for the company to be wound up. *Id.* at (b).

¹⁰³ Corporations Act, 2001, ch. 5, pt. 5.3A, div. 5, § 439A (Austl.). The 21-day period is extendable by court order. *Id.* at (6).

should: 1) enter into an arrangement with the creditors, 2) exit administration, or 3) be wound up.¹⁰⁴

If the creditors vote that the corporation should be wound up, the company begins the liquidation process by appointing a liquidator who then collects as much money as possible to maximize the return to the company's creditors.¹⁰⁵ The liquidator has extensive control over the company and exercises that control for the principal benefit of the company's creditors, subject only to the control of the court.¹⁰⁶ The liquidator additionally may bring legal proceedings in the company's name.¹⁰⁷

C. *Contractual Rights in Liquidation and Judicial Discretion*

The liquidator's control includes the right to collect any amount owed to the company from counterparties under contract.¹⁰⁸ The liquidator also has the power to disclaim a contract.¹⁰⁹ If the contract is for a lease or is unprofitable, no court approval is required for the liquidator to disclaim the contract.¹¹⁰ Other types of contracts can be disclaimed by obtaining court approval.¹¹¹ When a court allows a contract's disclaimer, the disclaimer affects the other party's rights only to the extent necessary to relieve the disclaiming company from liability.¹¹² The counterparty may then submit a creditor claim against the company in liquidation for damages suffered as a result of the effective disclaimer.¹¹³

¹⁰⁴ *Id.* at § 439C.

¹⁰⁵ See Corporations Act, 2001, ch. 5, pt. 5.4B, div. 2, § 477 (Austl.). The liquidator is to carry on the business of the company as long as necessary in order to favorably collect and disburse the value from the assets of the business. *Id.*

¹⁰⁶ See COLLIER INTERNATIONAL, *supra* note 85, pt. 14.04 (4)(b)(v)(B).

¹⁰⁷ Corporations Act, 2001, ch. 5, pt. 5.4B, div. 2, § 477 (2)(a) (Austl.).

¹⁰⁸ See *id.* at (1)(a), (2)(ca); *id.* div. 3, § 483 (3)(a).

¹⁰⁹ There are two key consequences of a disclaimed contract under the Corporations Act of 2001. *Enron v. TXU*, (2003) 48 A.C.S.R. 266, para. 57. First, the company in liquidation is deprived of any right to future performance upon the contract's disclaimer. Second, the counterparty's contractual rights are unaffected by the contract's disclaimer. See also *Enron Austl. Fin. Pty Ltd (in liq.) v. TXU Elec. Ltd*, (2005) N.S.W.C.A. 12, pp. 23-24 (citing the case below and generally agreeing with the reasoning of J. Austin).

¹¹⁰ See Corporations Act, 2001, ch. 5, pt. 5.6, div. 7A, § 568(1A) (Austl.). The liquidator need only sign a written disclaimer of the contract in question. *Id.* at (1).

¹¹¹ Corporations Act, 2001, ch. 5, pt. 5.6, div. 7A, § 568(h). The court may grant leave and "make such orders in connection with matters arising under, or relating to the contract; as the Court deems just and equitable." *Id.* (1B).

¹¹² Corporations Act, 2001, ch. 5, pt. 5.6, div. 7A, § 568D(1) (Austl.). This acts to limit the scope of the discretion of the courts in granting disclaimer of a contract that is not considered unprofitable. See *Enron Austl. Fin. Pty Ltd (in liq.) v. TXU Elec. Ltd* (2003) 48 A.C.S.R. 266, para. 57; discussion *infra* Part IV.

¹¹³ Corporations Act, 2001, ch. 5, pt. 5.6, div. 7A, § 568D(2) (Austl.).

Unprofitable contracts are defined with substantial breadth.¹¹⁴ The Australian courts have recognized this breadth, in keeping with the underlying policy goals of maximizing the return to a liquidating company's creditors in an expedient fashion.¹¹⁵ This policy conflicts with a liquidator's obligation to maximize returns for the creditors when a company in liquidation is a party to a favorable, yet long-term contract that might require performance over an extended period of time.¹¹⁶ The liquidator also carries on the business of the company to the extent necessary to provide maximum benefit the creditors.¹¹⁷ Whether the temporal or financial goals take precedence depends on the circumstances of the liquidation.¹¹⁸

The court has ultimate discretion to allow a disclaimer when a liquidator seeks court approval to disclaim a contract.¹¹⁹ It may impose additional conditions upon the parties, or make orders regarding matters "arising under, or relating to, the contract; as the Court considers just and equitable."¹²⁰ While the language appears to grant substantial discretion to the judiciary,¹²¹ the exercisable discretion remains limited by Section 568D, and Division 7A of Part 5.6, in Chapter 5 of the Corporations Act of 2001, which states that disclaimer does not affect any other party's rights, "except as far as necessary to release the company [in liquidation] and its property from liability."¹²²

Liquidators have a duty to seek the maximum benefit for creditors when winding up a company.¹²³ Courts have broad power in order to affect this goal.¹²⁴ Judicial discretion is narrowed by the opposing goal of completing the winding up process in a timely manner, and by a statutory limitation that seeks to avoid judicially rewriting contracts.¹²⁵

¹¹⁴ DUNS, *supra* note 32, at 239 (citing Dekala Pty. Ltd. (in liq.) v. Perth Land and Leisure Ltd. (1989) 17 N.S.W.L.R. 664 (suggesting that a showing of monetary loss is not absolutely necessary to show that a contract is unprofitable)).

¹¹⁵ See, e.g., Global Television Pty. Ltd. v. Sportsvision Australia Pty. Ltd. (in liq.) (2000) 35 A.C.S.R. 484, 496 (stating that a liquidator's obligation is to realize income from assets and disburse them to the creditors "at the earliest possible time").

¹¹⁶ See *id.*

¹¹⁷ Corporations Act, 2001, ch. 5, pt. 5.4B, div. 2, § 477(1)(a) (Austl.).

¹¹⁸ Whether a timely winding up is controlling over the liquidator's duty to maximize the profits, or vice versa, is beyond the scope of this Comment. For present purposes, it is enough to note these tensions within Australian insolvency law.

¹¹⁹ See Corporations Act, 2001, ch. 5, pt. 5.6, div. 7A, § 568(1B) (Austl.).

¹²⁰ *Id.*

¹²¹ *Enron Austl.* (2005) N.S.W.C.A. 12, para. 25.

¹²² Corporations Act, 2001, ch. 5, pt. 5.6, div. 7A, § 568D(1) (Austl.); see discussion *infra* Part. IV.

¹²³ See COLLIER INTERNATIONAL, *supra* note 85, pt. 14.04 (4)(b)(v)(B).

¹²⁴ See Corporations Act, 2001, ch. 5, pt. 5.6, div. 7A, § 568(1B) (Austl.).

¹²⁵ See discussion *infra* Part IV.C.

IV. LIMITS ON JUDICIAL DISCRETION PREVENTED ENRON AUSTRALIA FROM REALIZING THE BENEFIT OF THE SWAP CONTRACT

Enron Australia's liquidators failed to realize money allegedly owed under the Master Agreement.¹²⁶ The liquidators sought court approval to disclaim the swap contract with TXU, conditioned on the declaration of an early termination date.¹²⁷ Although the court's decision resulted in a windfall to TXU, the court properly recognized that it was without discretion to grant the qualified disclaimer.¹²⁸

A. *Enron Australia's Liquidators Were Unable to Realize the Financial Benefit of the Swap Agreement*

On December 2, 2001, Enron Australia, a foreign subsidiary of Enron in the United States, entered into voluntary administration as a result of Enron's now infamous financial collapse.¹²⁹ On January 29, 2002, Enron Australia's creditors voted to place the company into liquidation.¹³⁰ Enron Australia had entered into an electricity swap agreement with TXU.¹³¹ The parties memorialized their swap contract using the Master Agreement.¹³² Under the agreement's terms,¹³³ Enron Australia committed an event of default when it entered into voluntary administration, and continued in default when its creditors voted it into liquidation.¹³⁴ Under the Master Agreement's flawed asset provision,¹³⁵ TXU's payment obligations were suspended.¹³⁶ TXU also had the contractual right to declare an early

¹²⁶ See *infra* Part IV.A.

¹²⁷ See *infra* Part IV.B.

¹²⁸ See *infra* Part IV.C.

¹²⁹ *Enron Austl. Fin. Pty Ltd (in liq.) v. TXU Elec. Ltd* (2003) 48 A.C.S.R. 266, para. 2; see also Interview by ceoforum.com.au with Paul Quilkey, former Managing Director, Enron Australia (Nov. 2002), at http://www.ceoforum.com.au/200211_ceoinsight.cfm [hereinafter Quilkey Interview] (discussing the effects of Enron's bankruptcy in the United States on the Australian subsidiary).

¹³⁰ *Enron Austl.* (2003) 48 A.C.S.R. 266, para. 2; see *supra* Part III.B for the discussion of the procedure from voluntary administration to liquidation.

¹³¹ *Enron Austl.* (2003) 48 A.C.S.R. 266, paras. 5-7. There was also an agreement entered into by Enron Australia with Yallourn Energy Pty. Ltd.; however, to the extent that these two agreements are afforded similar treatment by the New South Wales Supreme Court, only the situation involving TXU will be addressed in this Comment.

¹³² *Id.*, para. 6; see *supra* Part II.

¹³³ 1992 Agreement, *supra* note 6, § 5(vii) (regarding an event of "bankruptcy" as an event of default); see also *supra* Part II.B. (discussing the relevant events of default).

¹³⁴ *Enron Austl.* (2003) 48 A.C.S.R. 266, para. 14. The appointment of an administrator constitutes an event of default under Section 5(vii)(6), while Section 5(vii)(5) includes the winding-up or liquidation of a company to be an event of default. 1992 Master Agreement, *supra* note 6, § 5(vii).

¹³⁵ 1992 Agreement, *supra* note 6, § 2(a)(iii)(1).

¹³⁶ See discussion *supra* Part II.C.

termination date as a result of Enron Australia's default.¹³⁷ However, terminating all outstanding transactions would result in TXU owing an estimated net amount of \$3.3 million (Austl.) to Enron Australia.¹³⁸ TXU had the option, but not the obligation, to declare an early termination date, and subsequently chose not to exercise that option.¹³⁹ This left Enron Australia's liquidators with an unrealizable but active contract that effectively held them in limbo.¹⁴⁰

B. Enron Australia's Liquidators Sought a Partial Disclaimer of the Swap Agreement

Enron Australia's liquidators attempted to collect under the Master Agreement by seeking leave of the court to disclaim the contract.¹⁴¹ The liquidator's argument relied on the Additional Termination Event provision contracted by the parties¹⁴² that entitled Enron Australia to set an early termination date upon Enron's satisfaction of all payment obligations, when no future payment obligations to TXU remained.¹⁴³ This situation would be satisfied when all transactions entered into under the Master Agreement expired.¹⁴⁴ Furthermore, the liquidators claimed that setting an early termination date at that time would entitle them to payment of the accrued net amount owed under TXU's suspended payment obligation.¹⁴⁵ Enron Australia's liquidators advanced a unique argument in an effort to currently realize the potential amount claimed to be owed by TXU.¹⁴⁶ The liquidators suggested that the provisions of the Corporations Act of 2001, which address the disclaimer of contracts in liquidation,¹⁴⁷ allowed the judiciary sufficiently broad discretion to give the court the power to approve the disclaimer of the Master Agreement, while simultaneously issuing an order

¹³⁷ 1992 Agreement, *supra* note 6, § 6(a).

¹³⁸ *Enron Austl.* (2003) 48 A.C.S.R. 266, para. 8. This is the amount calculated by Enron Australia at the commencement of the litigation discussed herein; *see infra* Part IV.B.

¹³⁹ *Enron Austl.* (2003) 48 A.C.S.R. 266, paras. 18-19.

¹⁴⁰ *See* discussion *infra* Part V.

¹⁴¹ *Enron Austl.* (2003) 48 A.C.S.R. 266, para. 25.

¹⁴² *See* discussion of Additional Termination Events *supra* Part II.D.

¹⁴³ *Enron Austl.* (2003) 48 A.C.S.R. 266, paras. 21-22. These are the terms of the Additional Termination Event that Enron Australia and TXU contracted for in Part 1(h) of the Schedule to the 1992 Master Agreement. *Id.*; *see* 1992 Schedule, *supra* note 6, pt. 1(h).

¹⁴⁴ *Enron Austl.* (2003) 48 A.C.S.R. 266, para. 21.

¹⁴⁵ *Id.*, para. 23. *But see* discussion *infra* Part V.A.

¹⁴⁶ *Id.*

¹⁴⁷ Corporations Act, 2001, ch. 5, pt. 5.6, div. 7A, § 568 (Austl.).

that had the identical effect of designating an Early Termination Date.¹⁴⁸ This would allow Enron Australia to collect the net amount owed, as calculated under the terms of the Master Agreement.¹⁴⁹

The liquidators argued that: 1) under Section 568 of the Corporations Act of 2001, the judiciary may grant the disclaimer of the Master Agreement, thus relieving Enron Australia's obligations under the contract,¹⁵⁰ and 2) the judge additionally has the power to make the supplemental order to effect an Early Termination Date under Section 568 (1B)(b) of the Corporations Act, as an order "in connection with matters arising under, or relating to, the contract."¹⁵¹

C. *The Supreme Court of New South Wales Correctly Decided the Limitations on Judicial Discretion to Allow Contract Disclaimer*

On December 24, 2003, Judge Austin, sitting in the Supreme Court of New South Wales, heard Enron Australia's liquidators' arguments¹⁵² and determined that although the statutory language initially appeared to broadly grant significant power to the judiciary, the words themselves were limited by the context of the surrounding provisions.¹⁵³ Judge Austin noted that if the liquidators' request were to be granted, it would effectively impose an affirmative obligation on TXU that did not arise from the contractual terms, thus altering the original terms contracted for by the parties.¹⁵⁴ Furthermore, the effect of the Section 568D(1) was held to clearly limit the extent to which disclaimer may apply.¹⁵⁵

The effect of Section 568D(1) limiting the application of disclaimer is supported by a substantial body of case law¹⁵⁶ which recognizes two key

¹⁴⁸ *Enron Austl.* (2003) 48 A.C.S.R. 266, paras. 27-28.

¹⁴⁹ See discussion of close-out netting *supra* Part II.B.

¹⁵⁰ *Enron Austl.* (2003) 48 A.C.S.R. 266, para. 27.

¹⁵¹ Corporations Act, 2001, ch. 5, pt. 5.6, div. 7A, § 568 (1B)(b) (Austl.).

¹⁵² *Enron Austl.* (2003) 48 A.C.S.R. 266, paras. 45-76. Enron's liquidators' support for their position relied on the breadth given to the interpretation of the statutory language "in connection with" and "relating to" in Section 568(1B)(b) of the Corporations Act of 2001, the increasing permissiveness of the allowance of disclaimer through the legislative history, and the general legislative intent behind the allowance of disclaimer for the purposes of winding up the company in an efficient and timely manner. *Id.*

¹⁵³ *Id.*, para. 40.

¹⁵⁴ *Id.*, para. 41. The original terms would be altered by allowing Enron Australia to effectively declare an early termination date when they are actively in default. Enron is thus not entitled to so declare under the terms of the agreement. See *supra* Part II.C-D.

¹⁵⁵ Corporations Act, 2001, ch. 5, pt. 5.6, div. 7A, § 568D(1) (limiting the extent to which disclaimer may affect the rights of other parties only to the extent necessary to relieve the disclaiming party from liability); see *supra* Part III.C.

¹⁵⁶ *Enron Austl.* (2003) 48 A.C.S.R. 266, para. 57.

aspects of disclaimer.¹⁵⁷ First, it is generally accepted that disclaimer deprives the disclaiming company of the right to future performance by the counterparty.¹⁵⁸ Second, the counterparty's vested rights arising under the contract are generally not to be affected by the disclaimer.¹⁵⁹ In order to be consistent with this precedent and give effect to Section 568D(1), Section 568(1B) cannot bestow so much power upon the court as to allow for the imposition of an order not arising from the original contract the liquidators seek to disclaim.¹⁶⁰

Judge Austin further supported his decision by noting that limiting the breadth of the statutory language is consistent with the general legislative intent behind the disclaimer provisions in the Corporations Act of 2001.¹⁶¹ He indicated that the disclaimer's purpose was to rid the company of burdensome property in order to facilitate the company's timely and efficient liquidation.¹⁶² The disclaimer provisions operate in detailed and specific manners in order to facilitate this goal.¹⁶³ Thus, the power to disclaim is limited and not all-inclusive.¹⁶⁴

On December 7, 2004, the New South Wales Court of Appeal heard Enron Australia's liquidators' appeal.¹⁶⁵ The court unanimously affirmed Judge Austin's opinion, and directly adopted the lower court's reasoning in multiple passages.¹⁶⁶ The liquidators' argument was against the weight of legal authority. Although the outcome is well-supported and appears to follow the letter of the law, its effects create some inequities, at least to

¹⁵⁷ *Id.*; see *supra* n. 109 and accompanying text.

¹⁵⁸ Corporations Act, 2001, ch. 5, pt. 5.6, div. 7A, § 568D(1) (disclaimer terminates the rights and interests of the disclaiming party to the disclaimed property); see *Enron Austl.* (2003) 48 A.C.S.R. 266, para. 57 (citing authority).

¹⁵⁹ Corporations Act, 2001, ch. 5, pt. 5.6, div. 7A, § 568D(1).

¹⁶⁰ See *Enron Austl.* (2003) 48 A.C.S.R. 266, para. 58 (agreeing with TXU's argument that the liquidator's proposed orders would alter TXU's existing right not to declare an early termination date under the Agreement, and is thus in conflict with Section 568D(1) of the Corporations Act of 2001).

¹⁶¹ See *Enron Austl.* (2003) 48 A.C.S.R. 266, paras. 72-76 (citing *Re Middle Harbour Inv. Ltd (in liq)* (No. 2) (1977) 2 N.S.W.L.R. 652, 657 (Austl.) (stating that the purpose of disclaimer is to rid the estate of burdensome contracts in an effort to facilitate the timely administration of the bankruptcy estate)).

¹⁶² See *Enron Austl.* (2003) 48 A.C.S.R. 266, para. 76; see also *Global Television* (2000) 35 A.C.S.R. 484, 489 (noting the same).

¹⁶³ *Enron Austl.* (2003) 48 A.C.S.R. 266, para. 76.

¹⁶⁴ *Id.*

¹⁶⁵ See *Enron Austl. Fin. Pty Ltd (in liq.) v. TXU Elec. Ltd*, (2005) N.S.W.C.A. 12. The three-judge panel reviewed the decision of the Supreme Court to determine whether Judge Austin erred in construing the scope of the statutory power of disclaimer conferred upon the court. *Id.* para. 5.

¹⁶⁶ See, e.g., *Enron Austl.* (2005) N.S.W.C.A. 12, paras. 23, 38 (citing opinion of Judge Austin, below). Because the reasoning of the New South Wales Supreme Court was so heavily relied upon, present discussion focuses on that court's reasoning. The most relevant and significant reactions were to the decision of the New South Wales Supreme Court's decision. See *infra* Part V.

Enron Australia's creditors.¹⁶⁷ Although Enron Australia's creditors in liquidation were not parties to the electricity swap here at issue, the question presents itself as to how much they knew about the Master Agreement's existence and terms contained therein, and how much Enron Australia's in-the-money position affected the extension of credit and accompanying terms.¹⁶⁸

V. WIDESPREAD REACTION BY MARKET PRACTITIONERS EXPOSED LEGITIMATE CONCERNS

The decision of the New South Wales Supreme Court and the subsequent affirmation by the Court of Appeal were well reasoned and properly decided. The seeming windfall received by TXU as a result of Enron Australia's inability to collect the sums allegedly owed caught the attention of many practitioners involved in corporate insolvency and derivative instruments.¹⁶⁹ While the consensus remains that the decision was legally sound,¹⁷⁰ the seeming inequity caused speculation as to the effects and implications of the decision.¹⁷¹ A significant concern is whether the basis of Enron Australia's claim—that the Additional Termination event would operate to allow Enron Australia to actually collect the amounts owed by setting an Early Termination Date at the expiration of all the outstanding transactions—was correct, thus eliminating the need for these proceedings.¹⁷² Such a determination would only serve to underscore the joint operation of the flawed assets provision and the non-defaulting party's

¹⁶⁷ The creditors were not parties to the Swap Agreement. It thus appears that the court was balancing the equities of enforcing the model provisions of a valid contract, and allowing a windfall to TXU, against the harm to the creditors of Enron Australia with regard to what is perhaps the poorly understood operation of the terms of the 1992 Master Agreement. *See infra* Part V.B.

¹⁶⁸ *See infra* Part V.C.

¹⁶⁹ *See, e.g.*, Walker & Usher, *supra* note 7 (citing the potential impacts of this decision, generally); MCMILLAN BINCH, *supra* note 13 (discussing the lack of an impact of the decision under Canadian law).

¹⁷⁰ *See, e.g.*, *Enron Austl.* (2005) N.S.W.C.A. 12 (affirming the decision of the lower court); Weinstein et al., *supra* note 13, at 4 (stating that the outcome is of minimal surprise).

¹⁷¹ Carter, *supra* note 13 (reporting that the Financial Services Authority of England asked the Bank of England to review the Enron Australia ruling as to the potential impacts on financial institutions); *see* Weinstein et al., *supra* note 13, at 4 (stating that the Financial Markets Lawyers Group of the Federal Reserve Bank of New York is reviewing the potential outcome under U.S. law, and the financial regulatory issues that may have been brought to light).

¹⁷² *See* MCMILLAN BINCH, *supra* note 13, at 5; *infra* Part V.A. The New South Wales Supreme Court followed this reasoning again when it determined Enron could designate an Early Termination Date under the 1992 Agreement. *Enron Austl. Fin. Pty Ltd (in liq.) v. Yallourn Energy Pty Ltd* (2005) N.S.W.S.C. 56, para. 26. The main issues before the court involved the amount of interest payable by each party. *Id.*, para. 11.

power to indefinitely suspend the election of a termination date, which would subversively cause the Master Agreement to operate contrary to the language on its face.¹⁷³ In allowing the non-defaulting party to walk away from its obligation, the outcome of this case is inconsistent with the Master Agreement's purpose and operation. While parties are generally indifferent to how creditors are treated in the event of liquidation, this shifting of risk will affect the relationship with both creditors and investors in the normal course of business.¹⁷⁴

A. *Enron Australia's Claim Was Based on a Faulty Assumption.*

Enron Australia's liquidators proposed that, under the terms of the Additional Termination Event, Enron Australia would have the right to declare an Early Termination Date upon the expiration of all of the underlying transactions.¹⁷⁵ Enron Australia's liquidators attempted (and failed) to persuade the court that such funds, due as a result of this alleged future right to realize the benefit of their position, should be currently collected.¹⁷⁶ While their argument was soundly defeated, the underlying presumption that they were entitled to the amount owed in the future is flawed.¹⁷⁷ The Additional Termination Event set forth by Enron Australia and TXU was not originally contemplated to operate in the event that a non-defaulting party refused to make payments or set an Early Termination Date.¹⁷⁸ The original purpose of the clause was to allow defaulting purchasers of an option, who have fully performed payment obligations, to obtain delivery despite the operation of the flawed asset provision.¹⁷⁹

A closer look at Enron Australia's liquidators' attempted application of the Additional Termination Event shows that this Additional Termination Event clause was not contemplated to apply under these circumstances, and would likely be ineffective in helping Enron Australia's liquidators to realize the benefit of any money owed. Upon the last outstanding agreement's expiration, the Additional Termination Event would allow Enron Australia to

¹⁷³ See *infra* Part V.B.

¹⁷⁴ See *infra* Part V.C.

¹⁷⁵ *Enron Austral. Fin. Pty Ltd (in liq.) v. TXU Elec. Ltd* (2003) 48 A.C.S.R. 266, para. 21.

¹⁷⁶ See *supra* Part IV.B.

¹⁷⁷ MCMILLAN BINCH, *supra* note 13, at 4-5. *But see Yallourn* (2005) N.S.W.S.C. 56, para. 12 – 26 (where the court again accepted, after cursory discussion, that the 1992 Agreement provided Enron Australia with the contractual right to declare an Early Termination Date under the Additional Termination Event in the Schedule to the 1992 Agreement).

¹⁷⁸ CLAYTON UTZ, *supra* note 81.

¹⁷⁹ *Id.*

declare an Early Termination Date.¹⁸⁰ The amounts owed include the “Unpaid Amounts” under the Master Agreement,¹⁸¹ which are defined with respect to the “Terminated Transactions.”¹⁸² It is presumed that the election of an Early Termination Date would, in fact, arise from Enron Australia’s ongoing Event of Default.¹⁸³ Thus, only the transactions in effect immediately before the declaration of an Early Termination Date would be collectible.¹⁸⁴ The ability to make that declaration, however, is conditioned upon the expiration of each individual transaction (as the expiration of Enron Australia’s payment obligations). There would be no transactions in effect just before Enron Australia attempted to set an Early Termination Date. Thus, under this reasoning, such an event would not give rise to any payment obligation on the part of TXU. This result further demonstrates that it was not likely contemplated by the parties to the Agreement, or their creditors, that this Additional Termination Event was meant to apply on these facts.

B. The Master Agreement Contradicts the Purpose of the ISDA and the Terms of the Master Agreement I.

Those pleased with the decision in the *Enron Australia* case were happy that the terms of the Master Agreement could be enforced “as written.”¹⁸⁵ While this is true, the decision allowed the Master Agreement’s

¹⁸⁰ See *Enron Austl.* (2003) 48 A.C.S.R. 266, para. 22; see discussion *supra* Part ILC-D for the definition of these terms.

¹⁸¹ 1992 Agreement, *supra* note 6, § 14. Unpaid Amounts include the amount that becomes payable before or as a result of the Early Termination Date, and is still unpaid. *Id.*

¹⁸² The 1992 Master Agreement defines “Terminated Transactions” as:

[W]ith respect to any Early Termination Date (a) if resulting from a termination event, all Affected Transactions and (b) if resulting from an Event of default, all Transactions (in either case) in effect immediately before the effectiveness of the notice designating that Early Termination Date (or, if ‘Automatic Early Termination’ applies, immediately before that Early Termination Date).

Id.

¹⁸³ However, this is arguable. If it is treated as arising from the Additional Termination Event, without reference to the Event of Default, then unpaid amounts would include all transactions, via the definition of Affected Transactions. Affected Transactions are said to include all transactions, except in limited circumstances that do not apply here. *Id.* Even if Enron might be entitled to payment eventually, the delay in the liquidation process is significant and against one of the key underlying policies behind Australian insolvency law, of providing an orderly process with the minimal delay and expense. Harmer Report, *supra* note 93, pt. 1, § 2, para. 33. Furthermore, it is illogical for parties to intentionally allow the terms of a contract to drag out the liquidation process, and would certainly be significant to the creditors of a party under such an agreement.

¹⁸⁴ MCMILLAN BINCH, *supra* note 13, at 5.

¹⁸⁵ See, e.g. Weinstein, et al., *supra* note 13, at 4 (noting the widespread positive reaction triggered by this decision, that essentially enforced the contract as it was written).

terms to act in tandem to undermine the contract as it was written. Although a victory for freedom of contract ideologues, the outcome of this decision exposed circumstances in which the actual effect of the Master Agreement operates contrary to its underlying purpose.

The flawed asset provision in Section 2(a)(iii) of the Master Agreement, operating in conjunction with the right of the non-defaulting party to refrain from electing an Early Termination Date, effectively turns the Second Method into the First Method by indefinitely relieving the non-defaulting party of any obligation to make payments or declare an Early Termination Date.¹⁸⁶ The First Method allows the non-defaulting party to walk away from the agreement, since they have no obligation to repay the defaulting party if they are owed money after electing an Early Termination Date.¹⁸⁷ The Second Method disallows the non-defaulting party to walk away by requiring that either party pay the net amount owed when the transactions are closed out.¹⁸⁸ Unless Enron Australia's liquidators were entitled to recover funds under the Additional Termination Event,¹⁸⁹ they would never collect on the amounts owed under the Swap Agreement. This is also due to the fact that the Master Agreement has no termination date itself, and thus the flawed asset provision operates indefinitely to prevent the payment obligation of the non-defaulting party from arising. This effectively turns an election of the Second Method—an election that purports to disallow parties to walk away when they are found to have an obligation in the event of an early termination—into an election of the First Method, where the defaulting party has no hope of ever making a successful recovery.

The New South Wales Court of Appeals' decision exposed a substantial term of the Master Agreement as an ineffective, illogical, and inefficient flaw¹⁹⁰ that created a forced option for the liquidator of the defaulting party to either disclaim the contract as a whole,¹⁹¹ or to extend the liquidation proceedings for the sole purpose of potentially realizing the value

¹⁸⁶ See discussion *supra* Part II.B (discussing the choice of methods for determining payment in the event of default under the Agreement).

¹⁸⁷ See 1992 Agreement, *supra* note 6, § 6(e)(i).

¹⁸⁸ See *id.*

¹⁸⁹ See discussion *supra* part V.A.

¹⁹⁰ Even in the event that Enron Australia is entitled to payment upon the termination of all of the underlying transactions, the term still operates to draw out a contract that is not productive on anyone's account. See discussion *supra* Part V.A.

¹⁹¹ See *supra* Part III.C.

of the contract at the termination of the attendant transactions.¹⁹² End users of the Master Agreement have a strong interest in predictability of the outcome of an event governed by the terms of a contract.¹⁹³ Model contracts from third parties, like statutes, should be efficiently drafted using clear language, and thus render predictable outcomes.¹⁹⁴ The *Enron Australia* decision causes the Master Agreement to fail the ISDA's objective by rendering the Second Method superfluous.

Swap arrangements documented by the Master Agreement are often used to hedge a company's interest in a particular market,¹⁹⁵ and thus allow the party to lower the risk of loss incurred in a sudden downturn in the market or other financially tumultuous event.¹⁹⁶ By using a swap agreement as a hedging tool, the parties and their creditors reasonably expect that, in the event of potential financial failure, the hedging party will have the benefit of the hedge contract to offset some of the losses incurred.¹⁹⁷

Prior to January 1, 2005, swaps were often carried off balance sheets, only recognized by a note to the financial statement.¹⁹⁸ Smaller creditors of Enron Australia may not have known of the swap contracts under the Master Agreement. These parties would normally bear the risk of debtor insolvency. Enron Australia's larger creditors may have been aware of, and

¹⁹² This is precisely what the liquidator of Enron Australia was attempting to do. *Enron Austral. Fin. Pty Ltd (in liq.) v. TXU Elec. Ltd* (2003) 48 A.C.S.R. 266.

¹⁹³ See discussion *infra* Part V.C.

¹⁹⁴ This is particularly true for the ISDA, as one of its chief goals is to promote efficiency through their documentation. ISDA Mission, *supra* note 18.

¹⁹⁵ The use of swaps to hedge against risks in the markets of certain commodities such as electricity are referred to as commodity swaps. KOLB, *supra* note 30, at 702-03. Derivative instruments are no longer purely hedging instruments, and many investors now actively enter them as profit seeking investment and financing devices. This may have been the case for Enron Australia. Cf. Quilkey Interview, *supra* note 129 (discussing the investing practices of Enron in the electricity market). In such an event, the significance here of having the contract as an asset available in liquidation is increased. See discussion *infra* note 197.

¹⁹⁶ CLYDE P. STICKNEY & ROMAN L. WEIL, FINANCIAL ACCOUNTING 650 (11th ed. 2006).

¹⁹⁷ If there is expectation that the investment will create an asset for financing purposes, then there is even more expectation on the part of the creditors that it would be available in the event of the party's insolvency and/or liquidation. There, it would not be used as a hedge against a particular risk of Enron Australia, but would be a financing asset with an expected realizable value.

¹⁹⁸ See IAS PLUS, STANDARDS: IAS 39, <http://www.iasplus.com/standard/ias39.htm> (showing the history and amendment of IAS 39). This was likely the case for Enron Australia. Note that this was also what got Enron into trouble in the first place – hiding related party transactions off the balance sheet. Floyd Norris, *Accounting Rules Changed to Bar Tactics Used by Enron*, N.Y. TIMES, January 16, 2003, at C4. In the United States, similar changes for derivative and hedge accounting have already gone into effect. See generally, FINANCIAL ACCT. STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 149 (2003) (amending Statement 133 so as to limit the instances when hedge accounting can be used, and emphasizing disclosure and recognition of derivatives on the balance sheet), available at <http://www.fasb.org/pdf/fas149.pdf>.

given access to, the derivative documentation. If that were the case, those creditors should not have relied on the benefits of the Master Agreement in the event of Enron Australia's insolvency when deciding to extend credit.¹⁹⁹

Under the revised International Accounting Standard 39 ("IAS 39"), smaller creditors may improperly rely on the accounting for ISDA swap agreements.²⁰⁰ On January 1, 2005, the amendments to IAS 39 went into effect.²⁰¹ Companies are now required to carry derivative contracts at their fair value on the balance sheet.²⁰² Under these new standards, Enron Australia would have carried the Master Agreement as a positive asset on the balance sheet, though it was not realizable in liquidation. Creditors and the investing public, who only have the financial statements to rely on, have even more potential for unexpectedly bearing the risk of insolvency under the amended standard. Creditors likely consider the existence of the swap agreement with a positive value on the balance sheet when deciding whether to extend credit.²⁰³ When parties cannot properly rely on assets carried on the financial statements, the integrity of the financial statements becomes less reliable.

The Master Agreement operates against the general expectations and purpose of the ISDA where the in-the-money party is insolvent to provide a stable and predictable swap contract. Enron Australia's creditors most likely reasonably expected that the benefits of the hedge contract would be available to offset the losses suffered as a result of its insolvency and subsequent liquidation. This is evidenced by the fact that this potential ability for nonpayment is just now being recognized and enforced after years of the Master Agreement's use.²⁰⁴ Now that this operation in the Master Agreement is exposed, parties to existing agreements are likely to enforce this outcome more often.²⁰⁵ Of course, hedge contracts are usually designed to protect the party against the risk incurred because of unexpected

¹⁹⁹ See *infra* Part VI.A.

²⁰⁰ See IAS PLUS, STANDARDS: IAS 39, *supra* note 198.

²⁰¹ *Id.*

²⁰² INT'L ACCT. STANDARDS BD., IAS 39:FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT, http://www.iasb.org/uploaded_files/documents/8_63_ias39-sum.pdf. Fair value refers to the price of the underlying item to the derivative instrument on the market on the date the balance sheet is prepared. *Id.* To the extent that they are classified as an effective cash-flow hedge, the change in value is held in a separate equity account until the gain or loss is realized through payment or sale. *Id.*

²⁰³ The issue is thus raised as to what extent this is the most accurate accounting method for an agreement entered into under the 1992 Master Agreement, as it may not actually be available as an asset in the event of the in-the-money party's insolvency. See Walker & Usher, *supra* note 7, at 416.

²⁰⁴ Denis M. Forster, *Defusing the Time Bomb Exposed by Enron Australia v. TXU*, 25 No. 3 FUTURES & DERIVATIVES L. REP. 1 (2005).

²⁰⁵ See *id.* at 5 n. 21.

fluctuations in the market of the commodity that is the subject of the swap agreement,²⁰⁶ as opposed to the general financial risk of the contracting company. The creditors nonetheless may rely on the accounting for the swap agreement as an asset on the balance sheet when determining whether to extend credit.

C. *The Walk-Away Provision's Shifting of Risk Presents a Real Concern.*

Both the party entering into a swap contract and that party's creditors expect that a swap agreement will operate as a hedging tool.²⁰⁷ Creditors take a particular interest in a borrowing company's credit exposure.²⁰⁸ Derivative transactions in particular may be seen as potential assets available in the event the debtor becomes insolvent or is otherwise unable to meet its obligation.²⁰⁹ When the benefit of the swap contract is unexpectedly unavailable for the creditors' benefit, as was the case for the creditors of Enron Australia, the risk of loss under the swap agreement is shifted from the two contracting parties to the creditors of the defaulting party.

If the creditors had the opportunity to give the swap agreement a close vetting, and were in fact familiar with the terms of the Master Agreement, then arguably the creditors themselves, as sophisticated parties, rightly bear the risk of Enron's default under the Master Agreement.²¹⁰ It is likely that most creditors reasonably relied on the characterization of the swap contract in the financial statement notes, and had reason to believe that the amount owed would become due in the event of liquidation.²¹¹ Enron Australia's creditors thus bore an unexpected risk under the Master Agreement.²¹²

²⁰⁶ See generally STICKNEY & WEIL, *supra* note 196, at 489-91 (discussing basic accounting of hedges). In the case of Enron Australia and TXU's arrangement, the value of the swap agreement was tied to the price of electricity. *Enron Austl. Fin. Pty Ltd (in liq.) v. TXU Elec. Ltd* (2003) 48 A.C.S.R. 266, para. 6.

²⁰⁷ See discussion *supra* Part V.B. To the extent that the Swap Contract appears as a positive asset on the debtor's balance sheet, the creditors are presumed to reasonably rely on that asset in their decisions as to whether, and on what terms, to extend credit to the debtor.

²⁰⁸ See Waldman, *supra* note 14, at 1049 (noting that the credit risk of parties to swap agreements is especially of concern in the event of parties to OTC derivative transactions).

²⁰⁹ See Bergman, et al., *supra* note 14, at 16 (stating that in the event of a bank's insolvency and a net in-the-money position under a swap agreement, the termination payment would be an asset of the insolvent bank available for the depositors thereof); *supra* Part V.B.

²¹⁰ Whether Enron Australia, as a sophisticated party to the contract, should itself be responsible for the understanding of the operation of the 1992 Master Agreement in the event of its liquidation, and the appropriateness of accounting for the swap contract, are issues additionally raised by the outcome of this case.

²¹¹ See *supra* Part V.B.

²¹² Enron Australia itself bore some responsibility to understand the effect of insolvency on the swap contract, and to thereby communicate the potential outcome in the notes accompanying its financial

This unexpected shifting of the loss has potentially serious consequences in the marketplace, as creditors are unable to consider the potential inability to collect during insolvency at the time that they extended credit to the debtor. The fact that the benefits of the contract would not be available might realistically affect either the terms attached to the credit extended,²¹³ or whether credit should be extended in the first place. This is another example under the Master Agreement where the actual outcome does not conform to the expected result, thus demonstrating that the compromised predictability and clarity of the Agreement has second-order consequences.

This unanticipated transfer of risk to the creditors of the defaulting party gives rise to concerns for the potential of systemic risk.²¹⁴ By transferring the risk of loss outside of the immediate contractual relationship, the level of risk is less likely to be subject to quantitative measurement, thus hampering the ability of the parties to assess and accommodate their exposure. As a result, the default of an in-the-money party under a swap agreement governed by the Master Agreement²¹⁵ could prevent owed funds from being available to pay the obligations under another swap contract and shift the risk to a third party. The third party might become insolvent as a result of this lost asset. This could subject the creditors of the third party to the similar disappointed expectations as a result of the Master Agreement, thus creating a domino effect of risk transfer and default. While this doomsday scenario is remote,²¹⁶ the consequences of the potential risks are indeed tangible.²¹⁷

statements. This raises the more general question of to what extent, if any, third party drafters of contracts should be liable for adverse outcomes under their model contract. See discussion *infra* Part VI.B.

²¹³ Examples include: the interest rate attached to the debt, other payment terms such as the time for repayment, required principal payments, etc. It is enough to consider here that these terms would be considered and affected by the level of risk that the creditor deems associated with a particular debtor, as well as the availability (or absence) of certain assets, when determining the overall level of risk attached to the debtor.

²¹⁴ Walker & Usher, *supra* note 7. In the event that there is a fairly enclosed market, with a set number of participants engaged in an inter-related web of derivative contracts, the transfer of risk has the potential to create a domino effect of risk and loss transfer, which is systemic risk. See Bergman et al., *supra* note 14, at 30.

²¹⁵ Where the insolvent party is unable to collect under the agreement in circumstances similar to those in *Enron Australia*. See *supra* Part IV.

²¹⁶ See generally Craig H. Furfine, *Interbank Exposures: Quantifying the Risk of Contagion*, J. MONEY CREDIT & BANKING, Vol. 35, No. 1, Feb. 2003, at 111 (concluding that the systemic failure of banks is generally unlikely).

²¹⁷ See Waldman, *supra* note 14, at 1056-57 (recognizing that although unlikely, it is easy to envision a chain-reaction of defaults, illiquidity of the derivatives, and panicked-driven selling).

Market practitioners recognized the particular risks to regulated financial institutions that engage in credit derivative swaps under the Master Agreement regarding netting and capital adequacy requirements.²¹⁸ Whether the operation of the provisions as demonstrated by the *Enron Australia* case is significant enough to affect regulation of financial institutions is not yet clear.²¹⁹ However, this parallels concerns about the proper accounting for swap contracts with regard to the disclosure and valuation of assets, and the risks of recognizing those assets upon liquidation.

Beyond the complete collapse of a local market, the increased and uncertain risk may create certain compensatory upward adjustments. For example, the benefit of swap agreements as a potential asset will be limited. Credit will be extended more conservatively, and applicable rates will increase as a result of the increased risk borne by those extending credit to parties engaged in transactions under the Master Agreement. The higher cost of credit to companies engaging in the sale of a commodity could result in the overall increase of prices for the underlying commodity itself, which elicits a greater social interest for the impact on end-consumer markets.

VI. THE ISDA SHOULD RESPOND TO THE CONCERNS OF THE MARKET AND FULFILL ITS SELF-PROCLAIMED GOALS

The outcome of the *Enron Australia* decision triggered a rapid response across globe from practitioners who work with swaps and derivatives instruments.²²⁰ The private market has proven its ability to recognize, respond, analyze, and adjust to new and unexpected outcomes in light of this case. The very ability of the private market to be this aware and responsive may itself be sufficient for users of the Master Agreement to consider the potential effect exposed by the *Enron Australia* decision. Future negotiation of swap and derivative agreements memorialized by the Master Agreements will include a deeper consideration of the insolvency of an in-the-money party.

Although market participants were initially reactive, the outcome of the *Enron Australia* decision must be addressed by the ISDA in order to protect against the Master Agreement operating in a similar fashion without prior consideration by the contracting parties. The ISDA has an ethical obligation, if not a legal one, to ensure that the outcomes under its model

²¹⁸ See *supra* note 17.

²¹⁹ Forster, *supra* note 204 at 4; McMILLAN BINCH, *supra* note 13, at 3-4.

²²⁰ See *supra* note 171 and accompanying text.

agreements are foreseeable and that the provisions operate without subversive interactions. The ability of the private market to be flexible in adapting to new circumstances is a powerful one, and no legislation is required to resolve this situation.

A. *Private Market Participants and the ISDA Are Best Equipped to Address the Operation of the Master Agreement.*

The private markets in local and international swap and derivative practice have shown an expeditious and reactive ability in response to the outcome of the *Enron Australia* decision.²²¹ Some of the reaction has extended beyond the private rule makers to governmental inquiries.²²² The private market participants and private market regulators, such as the ISDA, are best equipped to efficiently address the interaction of the terms of the Master Agreement exposed by the *Enron Australia* decision. Enron Australia's liquidation has brought the interplay of the flawed asset provision and the right of the non-defaulting party not to elect an early termination date to the attention of the swap and derivative market participants. Thus, the parties to such agreements will recognize the operation of the Master Agreement to provide a windfall to a non-defaulting party to the expense of the creditors of the defaulted party. It is likely that both parties will consider the importance of the contract with regard to the price and obtainment of credit,²²³ and will give sufficient weight to how the swaps are accounted for and disclosed to creditors. The availability of the contract in the event of financial turmoil of the company might well be important enough to induce parties to contract around the outcome of the *Enron Australia* decision. Currently, however, there are many open contracts entered into under the 1992 Master Agreement.²²⁴ Counterparties to insolvent in-the-money parties will now try to enforce the contracts as written to avoid payment, similar to TXU.²²⁵ In order to minimize the

²²¹ *Id.*

²²² See, e.g., Carter, *supra* note 13 (noting that the Bank of England's Financial Markets Law Committee was reviewing the impact of the *Enron Australia* decision on regulation of capital netting for regulated financial institutions).

²²³ See discussion *supra* Part V.C.

²²⁴ TEN THEMES, *supra* note 18, at 2 ("The most widely used agreement in the OTC derivatives markets is currently the 1992 ISDA Master Agreement . . .").

²²⁵ See Forster, *supra* note 204, at 5.

potential risks from this behavior,²²⁶ the ISDA should amend the Master Agreement to prevent this subversive operation for future transactions.

B. The ISDA Is Obligated to Consider Another Option.

The ISDA, as a third-party drafter, has an ethical obligation to maintain predictability and explicit operation of the model agreements. The parties that use the Model Agreements to enter into derivative contracts are generally sophisticated.²²⁷ Thus, parties should have the ability to vet the model agreement in utilizing the agreements as contracts. However, the ISDA has, by the very nature of the organization, taken on a role of fostering and maintaining systemic stability.²²⁸ While there may be no legal liability of the ISDA to address the operation of the Master Agreement in this instance, the ISDA has a professional and ethical responsibility to the market and its participants to provide a contract that operates as each of the available options purport to on their face. This can easily be accomplished by altering the model agreement.

The ISDA has indicated that the outcome of the *Enron Australia* decision is desirable, and even expected.²²⁹ However, the question still remains as to why the Master Agreement would purport to allow for the choice of the Second Method, when there are subversive situations where the terms of the Agreement operate to render it all but ineffective.²³⁰ The ISDA released the 2002 version of the Master Agreement in order to update the agreement to current market practices.²³¹ The ISDA removed the First Method, which allowed for a non-defaulting party to walk away from any obligation to the defaulting party as an available option under the contract.²³² This indicates a clear intention to move away from allowing a party to walk

²²⁶ See *supra* Part V.A-B.

²²⁷ But see Waldman, *supra* note 14, at 1035 (questioning whether such parties as local school districts and municipalities are of sufficient sophistication to utilize derivatives). To the extent that any financially unsophisticated parties utilize the Master Agreements, real issues of obligations arise as to legal liability of third party drafters as providing legal services. See, e.g., Julee C. Fischer, Note, *Policing the Self-Help Legal Market: Consumer Protection or Protection of the Legal Cartel?*, 34 IND. L. REV. 121 (2000) (discussing the obligations of Nolo Press for providing model legal documents to generally unsophisticated consumers).

²²⁸ See ISDA Mission, *supra* note 18.

²²⁹ Weinstein et al., *supra* note 13, at 4 (quoting general counsel of ISDA).

²³⁰ See *supra* Part V.B.

²³¹ See AAR, *supra* note 13 (noting that the 2002 Master agreement removes the First Method as an option, and the same outcome would have occurred if Enron Australia's Swap Agreement had been governed by the 2002 Agreement).

²³² *Id.*

away from the agreement. By leaving the interaction of the flawed asset provision with the Second Method unaddressed, however, the ISDA continues to allow for the effects of the First Method to remain in the event of factual circumstances similar to those of *Enron Australia*.²³³

In order to put the effects of the First Method election properly to rest, the ISDA should adopt a compulsory termination date, with a flexible amount of time for parties to determine whether such an election is prudent. This will give greater transparency to the potential outcomes under the contract, allow greater certainty to the parties as to what they are bargaining for, and protect unknowing parties from an inequitable outcome such as that in *Enron Australia*.

A practical alternative to current the Master Agreement, which will rid the agreement of the lingering ability of a party to walk away from its obligation under the contract, can be found by looking to another derivative instrument. The Edison Electric Institute (EEI) has a model contract for use in utilities markets.²³⁴ The EEI Master Contract avoids the potential for the non-defaulting party to be able to walk away from its obligation. The EEI allows for the suspension of payments for ten business days upon an event of default, and provides the non-defaulting party the option to declare an early termination date during the period of suspended payment.²³⁵ Thus, there is some flexibility for the non-defaulting party, while providing certainty that the contract will expire at some point in time.

Currently, under the ISDA Master Agreement, the only other option open to the parties is to elect for an Automatic Termination Date to apply.²³⁶ The option put forth by the EEI suggests that there can be a balance of certainty and flexibility. While the length of time could certainly be variable and negotiated between the parties to the agreement, it would provide a greater certainty to the fate of the parties under the agreement, and greater confidence to the creditors of the respective parties that the benefit of the agreement will be available in the event of insolvency or liquidation.

²³³ This is assuming that Enron would not, in fact, ever be able to declare an early termination date under the Additional Termination Event contracted for. See *supra* Part V.A.

²³⁴ Edison Electric Institute, Master Power Purchase & Sale Agreement (2000), available at, http://www.eei.org/industry_issues/legal_and_business_practices/master_contract/contract0004.pdf [hereinafter EEI Agreement]. See generally Andrew S. Katz, *Using the EEI-NEM Master Contract to Manage Power Marketing Risks*, 21 ENERGY L. J. 269 (2000) (discussing the terms and operation of the EEI Model Agreement).

²³⁵ EEI Agreement, *supra* note 234, art. 5, § 5.7; Katz, *supra* note 234, at 291.

²³⁶ See discussion *supra* Part II.B.

VII. CONCLUSION

The *Enron Australia* decision exposed an inconsistency in the 1992 ISDA Master Agreement. It also showed how quickly market participants are capable of reacting to the unexpected operations of the Master Agreement's provisions. The market's ability to identify problems under the agreement should be harnessed to improve the Master Agreement's terms. Greater transparency of the effect of the flawed asset provision and the election of the Second Method will provide predictable outcomes consistent with the expectation of the parties to the agreement. Thus, the parties will be able to negotiate for outcomes that correspond to their underlying interests with particular regard to the terms and cost of financing. Furthermore, by providing for terms with greater certainty in the Master Agreement, the risks to third parties can be contained, and the potential for systemic risk kept at a minimum.

When a regulatory responsibility is taken up by a private organization such as the ISDA, there exists a responsibility on the part of the organization to the end users of the model forms to provide documentation that is in line with their leading role in the development of privately negotiated derivative instruments. In light of this responsibility, it is necessary for the ISDA to address the compromised clarity and purpose of the contract by 1) giving notice to the parties in the marketplace so that they can contract around the provisions, and 2) amending the provisions in the Master Agreement so that the default rules will avoid giving rise to the unexpected outcome, thereby making the risk more ascertainable and addressable.

Additional concerns remain. Most importantly, accounting authorities must elucidate the appropriate accounting for the swap agreements. Otherwise, reliance arguments and allegations of misleading accountings are likely to be raised and litigated. Also, financial regulatory authorities must clarify whether financial institutions and capital adequacy requirements are affected by this case. Finally, it is necessary to consider the accountability of organizations that take on a role of responsibility in the promotion and fostering of markets. Sophisticated market practitioners and participants must rely on their own instincts and analysis to catch the next volatile reaction before it happens.