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IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
FORT WORTH DIVISION

_____)	Chapter 11 Case
In re)	
MIRANT CORPORATION, <u>et al.</u> ,)	Case No. 03-46590 (DML)
)	Jointly Administered
Debtors.)	
_____)	Hearing Date and Time: October 1, 2003
)	at 10:30 a.m.
)	

**CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION'S
MOTION FOR DETERMINATION OF RECOUPMENT RIGHTS, OR
IN THE ALTERNATIVE, FOR RELIEF FROM THE AUTOMATIC STAY**

A HEARING WILL BE CONDUCTED ON THIS MATTER ON NOVEMBER 25, 2003 AT 10:30 A.M. BEFORE THE HONORABLE D. MICHAEL LYNN, UNITED STATES COURTHOUSE, 501 WEST 10TH STREET, FORT WORTH, TEXAS.

IF YOU OBJECT TO THE RELIEF REQUESTED, YOU MUST RESPOND IN WRITING, SPECIFICALLY ANSWERING EACH PARAGRAPH OF THIS PLEADING. THE RESPONSE SHALL INCLUDE A DETAILED AND COMPREHENSIVE STATEMENT AS TO HOW THE MOVANT CAN BE "ADEQUATELY PROTECTED" IF THE STAY IS TO BE CONTINUED.

UNLESS OTHERWISE DIRECTED BY THE COURT, THE DEBTOR AND/OR ANY OBJECTING PARTY MUST FILE A RESPONSE WITH THE CLERK OF THE BANKRUPTCY

COURT AT 501 WEST 10TH STREET, FORT WORTH, TEXAS, WITHIN TWELVE (12) DAYS FROM THE SERVICE OF THIS MOTION.¹

YOU MUST SERVE A COPY OF YOUR RESPONSE ON THE PERSON WHO SENT YOU THE NOTICE. IF THE DEBTOR DOES NOT FILE A RESPONSE AS REQUIRED, THE ALLEGATIONS IN THE CREDITOR'S MOTION FOR RELIEF FROM THE AUTOMATIC STAY SHALL BE DEEMED ADMITTED, UNLESS GOOD CAUSE IS SHOWN WHY THESE ALLEGATIONS SHOULD NOT BE DEEMED ADMITTED, AND AN ORDER GRANTING THE RELIEF SOUGHT MAY BE ENTERED BY DEFAULT.

¹ Under Bankruptcy Rule 9006(e) service by mail is complete upon mailing; under Bankruptcy Rule 9006(f), 3 days are added to the period for the filing of a response when notice of the period is served by mail. *See* Local Bankruptcy Rule 4001.1(b).

TO THE HONORABLE D. MICHAEL LYNN, UNITED STATES BANKRUPTCY JUDGE:

The California Independent System Operator Corporation (“CAISO”), movant herein, submits its Motion for Determination of Recoupment Rights, Or In the Alternative, For Relief from the Automatic Stay (the “Motion”), and respectfully represents as follows:

JURISDICTION

1. The CAISO does not dispute that this Court has jurisdiction to consider the Motion pursuant to 28 U.S.C. §§ 157 and 1334. This Motion is made pursuant to 11 U.S.C. §§ 362(d)(1) and (2), Rule 4001 of the Federal Rules of Bankruptcy Procedure, and Local Rule 4001 of the Local Bankruptcy Rules of the United States Bankruptcy Court for the Northern District of Texas.

RELIEF REQUESTED

2. The CAISO operates transmission in California and certain spot markets for electricity and capacity that are necessary for reliable operation of the grid. This motion addresses three and one-half months of pre-petition transactions by Mirant Americas Energy Marketing, L.P. (“MAEM”) with the CAISO that were settled after MAEM filed its petition on July 14, 2003. Pursuant to its Tariff (including Protocols) approved by FERC (the “CAISO Tariff”)² and the CAISO Settlement and Billing Protocol (the “SABP”), CAISO settles transactions by market participants on a monthly basis, collecting net amounts owed and then distributing the amounts collected to net creditors after deducting a Grid Management Charge payable to the CAISO. For each of the months in question, CAISO paid MAEM's net monthly credit either to the above-captioned debtors (collectively, the “Debtors”) or to a segregated escrow account (whose ownership is not the subject of this particular motion). The Debtors seek to re-write the CAISO's tariff by requiring the CAISO to pay gross credits (rather than net

² The CAISO Tariff is available online at <http://www.caiso.com/docs/2003/10/09/2003100914564226338.html>.

credits) for the months in issue -- funds that the CAISO does not collect from other market participants and, in any event, is not required by its Tariff to distribute to Debtor or any market participant. By this motion, CAISO seeks to affirm that the CAISO Tariff and SABP settlement procedures do not violate the automatic stay because the gross credits that Debtors have sought are not property of these bankruptcy estates, or, assuming *arguendo* that such gross credits are property of the estates herein, that the CAISO is entitled to exercise equitable rights of recoupment. Finally, to the extent the Court determines that the equitable doctrine of recoupment is inapplicable, the CAISO requests that the Court grant relief from or annul the automatic stay of 11 U.S.C. § 362(a) for the limited purpose of CAISO's exercise of its rights of recoupment and/or setoff under the CAISO Tariff and SABP.

3. This Motion is based upon this notice of motion, the memorandum of points and authorities contained herein, the Declarations of Michael Epstein (the "Epstein Declaration") and Roni L. Reese (the "Reese Declaration") filed and served concurrently herewith, the entire record of these cases and such other and further evidence and argument as may be presented to the Court prior to or at any hearing on this Motion.

PROCEDURAL BACKGROUND

4. Certain of the Debtors commenced their cases by the filing of voluntary petitions for relief under chapter 11 of the Bankruptcy Code on July 14, 2003. On August 18, 2003, Mirant EcoElectrica Investments I, Ltd. and Puerto Rico Power Investments, Ltd. commenced chapter 11 cases under the Bankruptcy Code. The Debtors continue to manage and operate their businesses as debtors in possession pursuant to sections 1107 and 1108 of the Bankruptcy Code.

5. The CAISO is advised that the Court granted the Debtors' motion for an order requesting that the Debtors' bankruptcy estates be jointly administered. The CAISO is further

advised that the Office of the United States Trustee for the Northern District of Texas formed two official unsecured creditors' committees on or about July 25, 2003.

6. On or about September 4, 2003, Debtor filed a "Motion of the Debtors for an Order Enforcing the Automatic Stay and Directing the Turnover of Property of the Estate" ("Debtor's Motion of September 4, 2003"), which requests an order prohibiting CAISO and other grid operators "from offsetting the amounts owed to the Debtors with any claims by them or any energy spot market participant against the Debtors for each of those respective billing periods without a lifting of the automatic stay" for any billing period that relates to pre-petition activity. See Debtor's Motion of September 4, 2003, p. 8 & Exh. A. In particular, the Debtor alleged that "with respect to CAISO for the month of June 2003, MAEM was owed approximately \$6.1 million, had obligations of approximately \$671,000 and was due a net payment of \$5.43 million" and "with respect to CAISO for the month of July 2003, MAEM was owed approximately \$2.59 million, had obligations of approximately \$169,000 and was due a net payment of \$2.42 million." Debtor's Motion of September 4, 2003, Exh. B ¶¶ 12 & 13. The CAISO filed a timely objection to the Debtor's Motion of September 4, 2003.

7. Contemporaneously with the filing of its Motion of September 4, 2003, the Debtors commenced an adversary proceeding bearing Adversary Proceeding Number 03-4349 (the "Adversary Proceeding") seeking, among other things, a finding that CAISO was in violation of the automatic stay and an order requiring the CAISO to turn over to the Debtors funds held by the CAISO in escrow. After discussions between the Debtors and the CAISO, the parties agreed that the Motion of September 4, 2003 would be consolidated with the above-referenced Adversary Proceeding. Subsequently, the CAISO advised the Debtors of its intent to

pursue the relief sought in this Motion, thereby obviating that aspect of the Adversary Proceeding dealing with the alleged violation of the automatic stay.

FACTUAL BACKGROUND

The Parties

8. Debtor MAEM is a marketer of energy products and sells and purchases energy through, among other channels, certain “spot markets” for electricity. In these markets, energy companies such as MAEM supply electrical power to, and purchase it from, spot markets managed and operated by “independent system operators” such as CAISO.

9. The CAISO is a non-profit public benefit corporation that was created in 1996, by the California legislature to operate the grid for transmission of electrical power throughout much of California, and to provide open access transmission services on a non-discriminatory basis. In order to operate the grid reliably and maintain a balance between the supply of electricity and the ever-changing demand, the CAISO administers certain wholesale markets for electricity and related services. Debtor MAEM uses transmission operated by the CAISO and participates in the wholesale markets administered by the CAISO pursuant to a Scheduling Coordinator Agreement originally dated December 1, 1997, a true and correct copy of which, together with documents evidencing the name change from Southern Company Energy Marketing L.P. to MAEM, is attached as Exhibits 1 through 3 to the Reese Declaration (the “SC Agreement”).

10. The Federal Energy Regulatory Commission has plenary authority to regulate the wholesale electricity markets. The CAISO is operated pursuant to its FERC Tariff.³

³ For the Court’s convenience, copies of the portions of the CAISO Tariff and SABP relevant to this Opposition are attached to the Epstein Declaration as Exhibit “1.”

The Debtors’ Right to Payment Under the CAISO Tariff Extends Only to “Net Credits”

11. Pursuant to the SC Agreement, MAEM has agreed, among other things, that “the [CA]ISO Tariff governs all aspects of scheduling of Energy and Ancillary Services on the [CA]ISO Controlled Grid, including (without limitation), the financial and technical criteria for Scheduling Coordinators, bidding, settlement, information reporting requirements and confidentiality restrictions...” SC Agreement, ¶ 2.A. In addition, MAEM agreed that it will perform of the obligations imposed under the CAISO Tariff and abide by the procedures developed by the CAISO and the billing and payment system employed by the CAISO. *Id.* at ¶ 2.B.

12. In general terms, the CAISO Tariff requires the CAISO to pay to (or collect from) Scheduling Coordinators on a monthly basis any net market credits (or debits), after first deducting the “grid management charge” and any other fees payable to the CAISO. Only the resulting net credits are deemed to be due and payable to market participants, and only to the extent those net credits are collected from other Scheduling Coordinators. In other words, the credits themselves do not represent property of any market participant until the CAISO’s netting function has been completed, and net debits have been collected from ISO Debtors.

13. Specifically, the CAISO Tariff provides that for each month of trading activity a “Scheduling Coordinator shall pay any net debit and *shall be entitled to receive any net credit* shown in any invoice on the Payment Date, whether or not there is a dispute regarding the amount of the debit or credit.” CAISO Tariff § 11.6.2 (emphasis added); *accord* SABP 4.4.6. With respect to grid management charge, the CAISO Tariff directs the CAISO to “transfer to the relevant ISO account sufficient funds to pay in full the Grid Management Charge falling due on

any Payment Day with priority over any other payments to be made” SABP 6.3.1.3; see also SABP 6.7.3.

14. On a Payment Date, every Scheduling Coordinator whose invoice shows a net debit, or a net amount owing to the CAISO, is required to pay the net amount owed to the ISO Clearing Account. CAISO Tariff § 11.10; SABP 6.3.1. The CAISO is then required to “calculate the amounts available for distribution to ISO Creditors.” CAISO Tariff 11.13; SABP 6.3.1.2. Only the amounts actually collected from Scheduling Coordinators are available for distribution to Scheduling Coordinators whose invoices show a net credit. If it is not possible to make payment in full to all Scheduling Coordinators whose invoices show net credits, the CAISO is required to “reduce payments to all ISO Creditors proportionately to the net amounts payable to them.” CAISO Tariff § 11.16.1; SABP 6.7.4.

15. When a Scheduling Coordinator defaults on a payment due to the CAISO, the CAISO Tariff directs the CAISO to “take any steps it deems appropriate against the defaulting Scheduling Coordinator to recover the Default Amount . . . including . . . exercising its rights of recoupment or set-off pursuant to SABP 6.10.2” SABP 6.7.3. The referenced Tariff section provides, in relevant part:

“**Set Off.** The ISO is authorized to recoup, set off and apply any amount to which any defaulting ISO Debtor is or will be entitled, in or towards the satisfaction of any of that ISO Debtor’s debts arising under the ISO Settlement and billing process. Each ISO Creditor and each ISO Debtor expressly acknowledges that the oldest outstanding amounts will be settled first in the order of the creation of such debts.”

SABP 6.10.2.

16. The CAISO has two Payment Dates per settlement month: one for the Preliminary Invoice, which typically includes nearly all of the payment or credit to or from the CAISO for the month (a “prelim”), and one for the Final Invoice, which includes only adjustments made since the Preliminary Invoice (and is typically much smaller than the preliminary payment or credit) (a “final”). Since the Debtors filed their petitions on July 14, 2003, the CAISO has settled Debtor’s pre-petition trading activity through seven Payment Dates: “prelim” and “final” payment dates for trading activity in May, June and July 2003, as well as a “final” payment date for April 2003. On each of these seven Payment Dates for which a pre-petition amount was owing to MAEM, the CAISO calculated the pre-petition amount due to MAEM under the CAISO Tariff and transferred those funds either to the Debtors or to an escrow account for the Debtors.

The Escrow Accounts and Forthcoming Pre-Petition Adjustments

17. Beginning in June 2000, prices in wholesale electricity markets rose to unprecedented levels that continued through the middle of the following year. Certain market participants have pursued claims for refunds with FERC. The Commission has ordered the CAISO and the California Power Exchange (the “Cal PX”) to rerun their settlement and billing systems for the period October 2, 2000 through June 20, 2001 using certain mitigated prices to determine the amount of refunds that will be owed by suppliers, including MAEM (the “FERC Refund Case”). See, generally, FERC Docket EL-95 00.

18. On July 24, 2003, FERC issued a ruling interpreting the Tariff of the Cal PX, directing the Cal PX to retain amounts otherwise due to Scheduling Coordinators that have ceased trading through the Cal PX as security for any obligations that may arise from the FERC

Refund Case. See Powerex Corporation v. California Power Exchange Corporation, 104 FERC ¶ 61,119 at p. 12. (2003). In light of this decision and out of an abundance of caution, the CAISO has held in escrow amounts that otherwise would be due to the Debtors based upon pre-petition settlements until an appropriate authority determines whether they are the property of the bankruptcy estate. The CAISO is preparing a comprehensive filing with FERC to address this and several related issues, which will request permission to return the escrowed funds to the Debtors.

19. At this time, CAISO has placed the sum of approximately \$10 million in escrow pending a resolution of whether such funds constitute property of the bankruptcy estate, and, if so, whether the payment of such funds to the Debtors is authorized by FERC. This sum continues to bear interest.

DISCUSSION

A. The CAISO's Recouping or Offsetting Is Appropriate Because the Amounts at Issue Did Not Constitute Property of the Debtors' Bankruptcy Estates and Thus Were Not Subject to the Provisions of 11 U.S.C. § 362.

Section 362 of the Bankruptcy Code provides, in relevant part, that the filing of a voluntary petition for relief under chapter 11 of the Bankruptcy Code operates as a stay of

“(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

...

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor ...”

11 U.S.C. § 362(a)(3), (6) and (7). Generally, the automatic stay is designed to avoid a “chaotic and uncontrolled scramble for the debtor’s assets in a variety of uncoordinated proceedings in different courts.” In re Frigitemp Corp., 8 B.R. 284, 289 (S.D.N.Y. 1981); In re Holtkamp, 669 F.2d 505, 508 (7th Cir. 1982). As a preliminary matter, therefore, in order to determine whether the automatic stay of Section 362 of the Bankruptcy Code applies, a Court must first determine whether the property at issue constitutes property of the estate.⁴ Price & Pierce Intern. V. Spicers Intern. Paper, 50 B.R. 25, 26 (S.D.N.Y. 1985), *citing* Amoco Pipeline Co. v. Admiral Crude Oil Corp., 490 F.2d 114, 116 (9th Cir. 1974).

In this case, the Debtor asserts it is “owed” more than the net credits on its monthly invoices – specifically, the sum of all credits showing on CAISO invoices, without deduction of the associated charges. The amounts sought by Debtor over and above the net credits that are payable under the CAISO Tariff do not constitute property of the Debtor’s bankruptcy estate. As explained above, the ISO Tariff requires the CAISO to perform a calculation of the net sums due to or due from a Scheduling Coordinator before making any distribution of funds. It is only this *net* sum that is, in fact, payable to any given Scheduling Coordinator, and only to the extent that those amounts are actually collected from Scheduling Coordinators who owe net sums. Between the time funds are received from Scheduling Coordinators who owe net payments and the time funds are distributed Scheduling Coordinators who are owed net sums (a time period of one business day), the funds are essentially held by CAISO in escrow for all market participants.

⁴ The commencement of a case under chapter 11 creates an estate comprised of all of the legal or equitable interests of the debtor in property as of the commencement of the case. 11 U.S.C. § 541(a).

In general, most courts have held that assets in escrow are not property of the estate, even though the debtor may have certain rights under an escrow agreement in the assets escrowed. 5 *Collier on Bankruptcy* ¶ 541.09A[2] at 541-53 (15th Ed. Rev. 2003). For example, in In re Twenty-Four Hour Nautilus Swim & Fitness Ctr., Inc., 81 B.R. 71 (D. Colo. 1987), the debtor had bank accounts with a bank and had entered into an agreement under which the bank agreed to credit provisionally to the debtor's accounts the amount of each credit card draft received by the debtor. As is the case with respect to the CAISO market, the provisional credits were to become final only upon final settlement between the debtor and the bank. Final settlement occurred 120 days after the original credit, during which time credit card users were permitted to dispute charges on their monthly statements. *Id.* at 72. In opposing the bank's motion for relief from stay to exercise its setoff rights under Section 553 of the Bankruptcy Code to charge back disputed drafts, the debtor's trustee argued that any chargeback would result in preferential treatment to the credit card users who disputed the charges. The bankruptcy court ruled that Section 553 did not apply to the proposed chargeback since the transaction was governed by the Uniform Commercial Code.

In affirming the decision of the bankruptcy court, the district court stated:

“Here the debtor did not have a property interest in the amounts only provisionally credited to its accounts. Rather, the debtor's interest in the amounts credited to its accounts at the ... bank would become unconditional only after the 120-day dispute period ended and settlement on the VISA drafts became final. Because the debtor had no right to amounts provisionally credited until

settlement became final, the bankruptcy estate is not entitled to the disputed amounts.”

Id. at 74. The district court noted in a footnote that the bankruptcy court had correctly found that Section 553 setoff did not apply to the case, since there was no obligation of the bank to the debtor with regard to the provisionally credited funds in dispute. Likewise, the district court noted that the amounts charged back could not be considered “preferential” transfers to the credit card holders because the funds charged back were never property of the debtor’s bankruptcy estate. Id. at 74, fn. 2.

Similarly, in In re Dolphin Titan International, Inc., 93 B.R. 508 (Bankr. S.D. Tex. 1988), the bankruptcy court denied the debtor’s motion to reject an agreement pursuant to which the debtor had agreed to deposit funds in a “Loss Fund Account” against which workers’ compensation claims were to be paid in part. The debtor contended that, if it were permitted to reject the agreement, it could recover the funds it had paid into the escrow account. The bankruptcy court found, among other things, that the agreement was not an executory contract, and that the Loss Fund Account did not constitute property of the debtor’s bankruptcy estate. The court stated, “Although the Debtor had a contingent right to excess funds, the Debtor had no right to withdraw money from the Fund at will. Pursuant to the agreement, only [the escrow holder] could determine when excesses in the Fund arose, and determine any return of excess to Debtor. ... [W]here the debtor has no claim or interest in the fund until all prior claims have been paid in full, [the fund] is not property of the estate.” 93 B.R. at 512. *See also* Matter of Missionary Baptist Foundation of America Inc., 792 F.2d 502 (5th Cir. 1986) (funds in escrow were property of the estate only once all contingencies to release of such funds were satisfied); In re Palm Beach Heights Development & Sales Corp., 52 B.R. 181, 183 (Bankr. S.D. Fla. 1985)

(“The debtor may not have any part of [a fund created to cover the cost of public improvements] until such time as the debtor establishes that all prior claims in the fund have been paid and that a residuum remains to which it is entitled.”); Matter of O.P.M. Leasing Services, Inc., 46 B.R. 661 (Bankr. S.D.N.Y. 1985) (funds paid to creditors out of security account in which the debtor had no interest until it fulfilled all of its reimbursement obligations were not property of the debtor’s estate and, therefore, debtor could not establish liability for preferential transfer, *citing* Gulf Petroleum, S.A. v. Collazo, 316 F.2d 257, 261 (1st Cir. 1963) (“[c]ourts of bankruptcy recognize that money held in escrow is not property which vests in the trustee in bankruptcy.”)); In re Cedar Rapids Meats, Inc., 121 B.R. 562, 568 (Bankr. N.D. Iowa 1990) (“... an escrow account sets aside funds in a special way, and ... under such an arrangement the only right a party possesses outside bankruptcy is a contingent right to the remainder.”)

In this case, the CAISO received only net payments due to the market, and held them in what is essentially an escrow account for the benefit of all of its market participants until net payments were distributed. Only after each Scheduling Coordinator’s rights, if any, to all or any portion of the funds held by the CAISO was calculated in a net amount (and only to the extent these funds were received by the CAISO) were any funds “due” to a Scheduling Coordinator. Thus, MAEM has no right to any individual amounts that were provisionally credited to MAEM’s account until such time as the CAISO’s netting function has been completed and any net payments received from Scheduling Coordinators who owed them. Only then would MAEM’s bankruptcy estate have had any recognizable interest in funds held by the CAISO.

B. Even if the Funds At Issue Were Property of the Debtors' Estates, the CAISO's Recoupment of the Sums Payable by the Debtor from the Sums Otherwise Payable to the Debtor Is Authorized.

Given the nature of the relationship between and among market participants in the CAISO market and the process by which invoices are generated, disputed, subject to review and adjustment through reruns and ultimately collected and paid, the particular credits on the Debtor's CAISO invoices represented one step in the single transaction between MAEM as a market participant and the other participants in the CAISO market. All such transactions are governed, in the aggregate, by the SC Agreement. The funds potentially payable to MAEM pursuant to the SC Agreement are calculated under the ISO Tariff and the SABP, and MAEM was entitled only to "net credits," as described above. As such, even if the credits on MAEM's CAISO invoice are found to constitute property of the Debtors' bankruptcy estates, which they are not, the equitable doctrine of recoupment permitted the CAISO to apply the funds to reduce the amount owed by the Debtors into the CAISO market.

The Fifth Circuit has held that recoupment "allows a defendant to reduce the amount of a plaintiff's claim by asserting a claim against the plaintiff which arose out of the same transaction to arrive at a just and proper liability on the plaintiff's claim." Matter of Kosadnar, 157 F.3d 1011, 1013 (5th Cir. 1998), *citing* In re United States Abatement Corp., 79 F.3d 393, 398 (5th Cir. 1996); In re Holford, 896 F.2d 176, 178 (5th Cir. 1990). This is consistent with the interpretation of the law of recoupment in other Circuits. *See, e.g., Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1399 (9th Cir. 1996) ("recoupment 'is the setting up of a demand arising from the *same transaction* as the plaintiff's claim or cause of action, strictly for the purpose of abatement or reduction of such claim.>"). Recoupment is an equitable doctrine which is "based on the premise that 'the defendant should be entitled to show that because of matters

arising out of the transaction sued on, he or she is not liable in full for the plaintiff's claim.” Id. at 1401. These Circuit Court decisions are consistent with the holding of the United States Supreme Court, in Reiter v. Cooper, 507 U.S. 258, 265 n. 2, 113 S.Ct. 1213, 1218 n. 2, 122 L.Ed.2d 604 (1993):

“... a bankruptcy defendant can meet a plaintiff-debtor's claim with a counterclaim arising out of the same transaction, at least to the extent that the defendant merely seeks recoupment. Recoupment permits a determination of the just and proper liability on the main issue, and involves no element of a preference.”

See Matter of Gasmark Ltd., 193 F.3d 371, 374 (5th Cir. 1999).

Simply stated, recoupment “involves ‘netting out debt,’ Oregon v. Harmon (In re Harmon), 188 B.R. 421, 425 (9th Cir. B.A.P. 1995), and is allowed ‘because it would be inequitable not to allow the defendant to recoup ... payments against the debtor's subsequent claim.’” U.S. Healthcare v. Madigan (In re Madigan), 270 B.R. 749, 754 (9th Cir. B.A.P. 2001).⁵ In Kosadnar, supra, the Fifth Circuit identified two (2) general requirements to characterize a creditor's action as recoupment: “first, some type of overpayment must have been made, and second, both the creditor's claim and the amount owed to the debtor must arise from a single contract or transaction.” 157 F.3d at 1014.

In Kosadnar, supra, as is the case here, the debtors sought to hold the debtor-husband's employer in contempt of court for violating the automatic stay. The debtors alleged that the employer was improperly withholding from the husband's post-petition paychecks sums for the

⁵ The Fifth Circuit has held that “to the extent that a party is entitled to recoupment of funds, ‘the debtor *has no interest* in the funds.’” Matter of U.S. Abatement Corp., supra, 79 F.3d at 398 (emphasis in original). This is consistent with the CAISO's position that, until the debits and credits of a particular market participant have been netted out, there is no property interest in the funds administered by the CAISO. Only the net amount calculated is properly allocable to any market participant including, without limitation, the Debtors.

repayment of prepetition commission advances and unearned commissions. Both the Bankruptcy Court and the District Court concluded that the employer's action was in the nature of recoupment and not an inappropriate setoff. The Fifth Circuit affirmed, finding that all of the claims between the husband and his employer arose out of a single employment contract between the parties, and that, therefore, the recoupment doctrine was appropriate. Id. at 1015. In reaching its conclusion, the Fifth Circuit stated:

“There is no general standard governing whether events are part of the same or different transactions. ‘Given the equitable nature of the (recoupment) doctrine, courts have refrained from precisely defining the same-transaction standard, focusing instead on the facts and the equities of each case.’ United States ex rel. United States Postal Serv. v. Dewey Freight Sys., Inc., 31 F.3d 620, 623 (8th Cir. 1994); see also Official Comm. Of Unsecured Creditors of Baja Boats, Inc. v. ITT Commercial Fin. Corp. (In re Baja Boats, Inc.), 1996 WL 521416, at *3 (Bankr. N.D. Ohio, July 24, 1996) (“Whether the obligations arose from the same transaction is to be determined by the facts and equities of the particular case.”).”

Id.; see also Holdford v. Powers, 896 F.2d 176 (5th Cir. 1990); Continental Casualty Co. v. Gullett, 253 B.R. 796, 804 (S.D. Tex. 1999) (stating that recoupment was proper because “it would be inequitable for the debtor to enjoy the benefits of the transaction without also meeting its obligations.”) citing Malinowski v. New York State Dept. of Labor, 156 F.3d 131, 132 (2d Cir. 1998); Sims v. U.S. Department of Health and Human Services (In re TLC Hospitals, Inc.), 224 F.3d 1008, 1012 (9th Cir. 2000) (“... the crucial factor in determining whether two events are

part of the same transaction is the ‘logical relationship’ between the two. ... a ‘transaction’ may include ‘a series of many occurrences, depending not so much upon the immediateness of their connection as upon their ‘logical relationship.’”) Recoupment may be employed to recover a pre-petition obligation of a debtor from a post-petition obligation to the same debtor under appropriate circumstances. Id.

This case is similar to the facts before the Tenth Circuit Court of Appeals in In re B & L Oil Co., 782 F.2d 155 (10th Cir. 1986). In B & L, the debtor executed an “oil division order,” pursuant to which the creditor obtained the right to purchase unspecified amounts of crude oil the debtor produced. The creditor’s payment obligation was determined independently for each oil delivery made by the debtor under the oil division order. The creditor overpaid for oil produced and delivered by the debtor; after the debtor commenced its bankruptcy case, the creditor withheld funds from payments owed to the debtor for subsequent oil deliveries in order to recover the amount of its prepetition overpayment. The creditor brought an action in the bankruptcy court seeking a declaration that it had properly recouped its overpayment and that it would be entitled to recoup from future purchases the remaining amount it had overpaid. The bankruptcy court held that recoupment was improper because the debts did not arise from the “same transaction.” The district court affirmed.

In reversing the district court, the Tenth Circuit analogized the situation in B & L to advance royalties payable to a writer or musician which were subject to recoupment out of future royalties, or Medicare overpayments to a hospital that could be recouped against payments owed the hospital for patients treated after the commencement of the bankruptcy case. 782 F.2d at 158-159. One of the factors which was considered by the Tenth Circuit was whether the parties’ underlying agreement expressly permitted the withholding of overpayments from future

payments. Citing Lee v. Schweiker, 739 F.2d 870 (3d Cir. 1984), the Tenth Circuit stated that recoupment was proper where the contract between the parties “provided for advance payments based on estimates of what ultimately would be owed, subject to later correction.” Id. At 157.⁶ See also In re University Medical Ctr., 973 F.2d 1065 (3d Cir. 1992) (recoupment often applied where the claims arise from a contract which calls for advance payments based on estimates of what will be owed, with the actual amount owed determined later); In re AHN Homecare, L.L.C., 222 B.R. 804 (Bankr. N.D. Tex. 1998) (same).

Another case with facts analogous to those now before the Court is In re R & C Petroleum, Inc., 247 B.R. 203 (Bankr. E.D. Tex. 2000). In R & C, the debtor and creditor were parties to a “Gas Gathering Agreement” which provided that the creditor would accept gas from the debtor into the creditor’s gas pipeline facilities, and that the creditor would transport the gas to certain destination points for delivery to the debtor’s customers. In exchange for the service provided, the creditor was entitled to receive a monthly “gathering charge” based upon the volume of the debtor’s gas transported during that month. During the parties’ performance under the Gas Gathering Agreement, gas imbalances arose from time to time when the debtor delivered more gas into the gathering system than its customers received from the gathering system, or *vice versa*. After the commencement of the debtor’s bankruptcy case, the creditor argued that it was entitled to recoup the amounts owing from the debtor from the amounts otherwise payable to the debtor under the Gas Gathering Agreement because, among other things, the Agreement “contemplate[d] a final ‘netting’ of accounts and settling of amounts.” Id. at 207. The court in R & C agreed that recoupment was proper since the underlying agreements “involve[d] a process

⁶ The Tenth Circuit noted, however, that the application of the equitable doctrine of recoupment “should not depend on whether the parties expressly anticipated the problem.” Id. At 159.

of estimating in advance the amount of services to be used and later correcting the parties' accounts to resolve overpayments." Id. at 208.

Similarly, in this case, the CAISO and MAEM engage in a series of transfers pursuant to the SC Agreement based upon transmission of electricity over the grid operated by the CAISO. As noted above, the CAISO Tariff and billing protocol contemplates an ongoing series of transactions between and among the various market participants yielding obligations to and obligations from such market participants, and the SC Agreement, the CAISO Tariff and the SABP all specifically contemplate recoupment by the CAISO. The parties' relationship is premised upon the "netting" performed by the CAISO, and each invoice generated reflects the total credits and debits of a market participant.

Under these facts and circumstances, the Court should conclude that the computation of the amounts payable to MAEM and the accompanying calculation of amounts payable from MAEM under the SC Agreement and CAISO Tariff was a single, integrated transaction which is subject to the doctrine of recoupment. This is consistent with the concept that recoupment is appropriate "when the counterclaim arises from the same aggregate set of operative facts as the initial claim, in that the same operative facts serve as the basis of both claims or the aggregate core of facts upon which the claim rests activates additional legal rights otherwise dormant in the defendant." Pinkstaff v. United States (In re Pinkstaff), 974 F.2d 113, 115 (9th Cir. 1992). Given the CAISO's relationship with MAEM, the Court should conclude that the obligations of both the ISO and the Debtor were "sufficiently interconnected so that it would be unjust to insist that one party fulfill its obligation without requiring the same of the other party." Madigan, supra at 755.

- C. *If the Court Concludes that Recoupment is Inapplicable, the Court Should Not Require the CAISO to Deliver Funds to the Debtors and Should Annul or Grant Relief From the Automatic Stay for the CAISO to Exercise its Right of Setoff.*

Section 362 of the Bankruptcy Code provides, in relevant part:

“(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay –

(1) for cause, including the lack of adequate protection of an interest in property for such party in interest;

(2) with respect to a stay of an act against property under subsection (a) of this section, if –

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization...”

11 U.S.C. § 362(d)(1), (2). To the extent the Court concludes that the funds held by the CAISO are property of the estate subject to the automatic stay, and that the transactions between the CAISO and the Debtors do not meet the standards to permit recoupment, the CAISO submits that there is sufficient cause for the Court to annul or grant relief from the automatic stay with respect to the CAISO’s exercise of its right of offset under Section 553 of the Bankruptcy Code.

1. *There is “Cause” To Grant Relief from Stay*

What constitutes “cause” for lifting of the automatic stay is not clearly defined in the Bankruptcy Code, and must be determined on a case by case basis. Matter of Reitnauer, 152

F.3d 341, 343 fn. 4 (5th Cir. 1998); In re Tucson Estates, Inc., 912 F.2d 1162 (9th Cir. 1990). The concept of “cause” is intentionally broad and flexible so as to permit a court to respond to the facts and circumstances of each case presented. In re Texas State Optical, Inc., 188 B.R. 52 (Bankr. E.D. Tex. 1995).

Section 553 of the Bankruptcy Code provides that, except as limited by the automatic stay of Section 362, the Bankruptcy Code “does not affect the right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case.”⁷ 11 U.S.C. § 553(a). The right of setoff allows entities that owe each other money “to apply their mutual debts against each other, thereby avoiding ‘the absurdity of making A pay B when B owes A.’” Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 18, 116 S.Ct. 286, 289, 133 L.Ed.2d 258 (1995); In re Kosadnar, supra at 1014; Matter of Holdford, supra at 178 (“setoff involves a claim of the defendant against the plaintiff which arises out of a transaction which is different from that on which the plaintiff’s claim is based.”).

If a party is generally entitled to setoff in the non-bankruptcy context, it is entitled to one under the Bankruptcy Code. Butner v. United States, 440 U.S. 48, 55, 99 S.Ct. 914, 918, 59 L.Ed.2d 136, 141-142 (1979) (“Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.”); In re Davidson Lumber Sales, Inc., 66 F.3d 1560, 1564-1565 (10th Cir. 1995);

⁷ With respect to the portion of the funds held by the CAISO that relate to post-petition transactions, if any, Section 553 is inapplicable, and the CAISO does not need relief from the automatic stay to exercise its offset rights. See 3 Collier on Bankruptcy ¶ 362.03(9) at 362-36 n. 126 (15th Ed. Rev. 2001) (“11 U.S.C. § 362(a)(7) does not stay setoff of postpetition debts and credit.” Citing Zion First Nat’l Bank v. Christiansen Bros., Inc. (In re Davidson Lumber Sales, Inc.), 66 F.3d 1560, 1569 (10th Cir. 1995); see also 5 Collier on Bankruptcy ¶ 553.03(6) at 553-56 (15th Ed. Rev. 2001) (“... a postpetition claim may be offset against a postpetition debt so long as the claim and debt constitute valid, mutual obligations.”).

Hal, Inc. v. U.S. (In re Hal, Inc.), 122 F.3d 851, 852 (9th Cir. 1997). One commentator has noted that, “(a)s a general rule, unless the creditor’s alleged setoff right is patently invalid, relief from the stay to permit the creditor to interpose its right in an action brought by (a debtor in possession) against the creditor should be granted. Otherwise, the (debtor in possession) may be able to establish the estate’s claim and potentially enforce a judgment against the creditor without the creditor having the opportunity to establish what may otherwise be a perfectly valid right.” 5 *Collier on Bankruptcy* ¶ 553.06(1)(b) at 553-67 – 553-68 (15th Ed. Rev. 2003). In order to establish the right to setoff, a creditor must establish (1) a debt owed by the creditor to the debtor which arose prior to the commencement of the bankruptcy case; (2) a claim of the creditor which arose prior to the commencement of the bankruptcy case; and (3) the debt and claim must be mutual obligations. Matter of Luongo, 259 F.3d 323, 334 (5th Cir. 2001).⁸

Here, the CAISO submits that sufficient cause exists to warrant annulment of or relief from the automatic stay, to the extent this Court deems such action necessary, to protect and pursue the CAISO’s valid setoff rights. As one court stated, “if the right to set-off will not substantially interfere with the debtor’s reorganization effort, and has been obtained in good faith, equitable considerations favor lifting the automatic stay to allow set-off.” Row Steel, Inc. v. Asphalt & Sealers Equip. Mfg. (In re Row Steel, Inc.), 33 B.R. 20, 22 (Bankr. E.D.N.C. 1983); In re Davidson Lumber Sales, Inc., *supra*, 66 F.3d at 1569. Since the CAISO Tariff and billing protocol have always required the CAISO to setoff the amounts otherwise payable to a market participant against the amounts payable by the same market participant, the Debtors cannot have reasonably had any expectation regarding receipt of the gross amount of funds held by the CAISO on the Debtors’ account. To the contrary, if the CAISO was not permitted to net

⁸ All of these factors are satisfied in this case. There are sums due to and due from MAEM from the CAISO market under the CAISO Tariff, SC Agreement and SABP. These mutual obligations exist between the same parties standing in the same capacity.

the transactions, the Debtors would essentially be receiving a windfall at the expense of other market participants, who would necessarily receive less money than the net sums that were owed to them.⁹

2. *Relief From Stay is Appropriate Under § 362(d)(2) As Well*

Under Section 506(a) of the Bankruptcy Code, the claim of a creditor that is subject to setoff under Section 553 is a secured claim to the extent of the amount subject to setoff. 11 U.S.C. § 506(a). “Like any secured claim, therefore, an entity with a right to setoff is assured that the automatic stay will be lifted to permit the creditor to setoff unless ‘adequate protection’ is furnished ... It is a fundamental principle of bankruptcy law that the Court may not eliminate allowed secured claims without compensation equal to at least the value of the collateral.” In re Braniff Airways, Inc., 42 B.R. 443, 448 & 452 (Bankr. N.D. Tex. 1984); In re R.C.I. Enterprises, Inc., 22 B.R. 549, 551 (Bankr. S.D. Fla. 1982); In re Princess Baking Corp., 5 B.R. 587, 590 (Bankr. S.D.Cal. 1980). Since the amount of a creditor’s secured claim based upon a right of setoff is equal to the amount subject to setoff, there is, by definition no “equity” in the funds held, and such funds constitute the creditor’s cash collateral subject to the provisions of Section 363 of the Bankruptcy Code.¹⁰ In re R.H. Williams, 61 B.R. 567, 572 (Bankr. N.D. Tex. 1986).

“Adequate protection” for purposes of Sections 362 and 363 of the Bankruptcy Code is defined to include, to the extent the use of the cash collateral results in a decrease in the value of such collateral, (i) periodic cash payments; (ii) an additional or replacement lien; or (iii) such other relief as will allow the entity to realize the “indubitable equivalent” of such entity’s interest in such property. 11 U.S.C. § 361. This list of the forms of adequate protection available is

⁹ The transactions here at issue all relate to pre-petition time periods. The CAISO is not attempting to setoff any pre-petition transaction against a post-petition transaction.

¹⁰ Section 363 of the Bankruptcy Code provides, in relevant part, that the Debtors may not use cash collateral unless either the CAISO consents to such use, or the Court, after notice and a hearing, authorizes the Debtors’ use of the cash collateral. 11 U.S.C. § 363(c)(2).

neither exclusive nor exhaustive, and the burden falls to the debtor to propose a suitable form of adequate protection under the facts and circumstances of each case. In re Princess Baking Corp., 5 B.R. 587, 591 (Bankr. S.D. Cal. 1980).

In this case, given the magnitude of the assets and liabilities involved, the funds here at issue will not have a material impact upon the outcome of this reorganization case. MAEM has no equity in the funds held in escrow by the CAISO, and such funds are not necessary for an effective reorganization. To the extent MAEM seeks access to the funds held by CAISO to use such in the operation of its business, the funds shall be dissipated and CAISO's setoff right extinguished. Under these circumstances, the CAISO's interest in the funds is not adequately protected and relief from the automatic stay is warranted and appropriate.

CONCLUSION

WHEREFORE, the CAISO respectfully requests that the Court enter an order (i) finding that the individual credits on Debtor's pre-petition invoices from CAISO are not, and will not constitute, property of the Debtors' bankruptcy estate until all settlements required under the CAISO Tariff were completed and net amounts owing were collected for distribution; (ii) alternatively, concluding that the CAISO's actions are governed by the equitable doctrine of recoupment; (iii) alternatively, to the extent the Court concludes that the funds at issue were or are property of the Debtors' bankruptcy estates and that the doctrine of recoupment does not apply to the facts presented, annulling or granting the CAISO relief from the automatic stay with respect to CAISO's rights of setoff under Section 553 of the Bankruptcy Code; and (iv) granting

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that he has authorized In-House Attorney Service as service agent to cause to serve a true and correct copy of the foregoing Motion upon all parties listed below via email, facsimile or overnight mail and upon all persons on the Limited Service List via first class mail, postage prepaid on the 30th day of October, 2003 in accordance with the Federal Rules of Bankruptcy Procedure:

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