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Are All Collateral Provisions the Same?

NAPCO Credit Conference
Louisville, Kentucky

September 21-23, 2016

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Introduction

Credit Solutions

ISDA

NAESB

EEI

WSPP

Guaranties

Letters of Credit

Adequate Assurance

Threshold Margining

Prepayment

First Liens

**VEXING
ISSUES!**

NOT TO WORRY

Today we will be home in on **GUARANTIES** and **LETTERS OF CREDIT**
and
**SIGNIFICANT DIFFERENCES BETWEEN
THE CREDIT SUPPORT DOCUMENTS**



ISDA Credit Support Annex

EEI Collateral Annex

NAESB Credit Support Addendum

WSPP Collateral Annex

Roadmap

I. Guaranties and Letters of Credit – Advantages and Disadvantages

Questions to answer:

- a. What is a guaranty?
- b. What is a letter of credit?
- c. How do they measure up?
- d. When is one better than the other?



Roadmap

II. Overview and Comparison of Standard Credit Support Documentation

- a. Assignment and transfer
- b. Adequate assurances
- c. Suspension rights
- d. Setoff
- e. Credit and collateral triggers
- f. Collateral characteristics
- g. Holding and using collateral
- h. Letters of credit
- i. Pledging party's rights
- j. Miscellaneous



Guaranties

- Third party (usually parent) agrees to pay
- Guarantee of payment not performance
- Enhances counterparty's creditworthiness
- Guarantor's right of subrogation
- Termination only releases Guarantor from future liability – not prior payment obligations

Guaranties

- When are Guaranties used?
- A party has:
 - Little or no creditworthiness;
 - Limited liquid collateral; and
 - An affiliate with creditworthiness

Guaranties

- Advantages:
 - Liquid (but see next slide)
 - Simple
 - Common
 - Generally quick to negotiate and implement
 - For beneficiaries, potentially adds value if Guarantor and subsidiary go bankrupt
 - Ex: Enron corporate guaranty roughly doubled unsecured creditors' recovery

Guaranties

- Disadvantages:
 - Contract obligation, not cash or property
 - Guarantor's creditworthiness may subsequently deteriorate
 - Guarantor is required to report guaranteed obligations on its financial statements

Guaranties

- Defenses to Payment:
 - Generally, Guarantor has same defenses as Counterparty under trading agreement
 - Exceptions:
 - Non-payment because of discharge of counterparty's obligations in bankruptcy
 - Non-payment because counterparty lacked capacity under the agreement
 - Any defenses expressly waived in guaranty
 - Suretyship defenses

Letters of Credit

- Financial institution agrees to pay up to the value of the letter of credit
- Second only to cash
- Generally short-term in nature
 - Common term is 30 days to 1 year

Letters of Credit

- Party posting the letter of credit is usually responsible for all related fees
- Fees Associated with Letters of Credit
 - Monthly fee to maintain the credit facility, whether or not letter of credit is issued
 - Usually a percentage of total amount available under letter of credit facility
 - Fee when letter of credit is actually issued

Letters of Credit

- Common Limitations Imposed by Issuer:
 - Maximum number of letters of credit
 - Maximum amount outstanding
 - Approval of beneficiary
 - Approval of form

Letters of Credit

- Drawing on a Letter of Credit:
 - Administrative Obstacles
 - Compliance with drawing conditions
 - May require an officer of the beneficiary to present the draw request to the issuer.
 - Default under agreement generally must be continuing
 - May be required to present certified statement of default
 - Physical presentation of letter of credit to issuing bank
 - Ability (or inability) to make partial and/or multiple withdrawals
 - Depends on express terms in letter of credit

Letters of Credit

- Multiple and partial withdrawals are preferred
- If not allowed, then:
 - Beneficiary may draw on letter of credit only one time
 - So - wait until the maximum amount allowed under the letter of credit is owed before drawing on the letter of credit

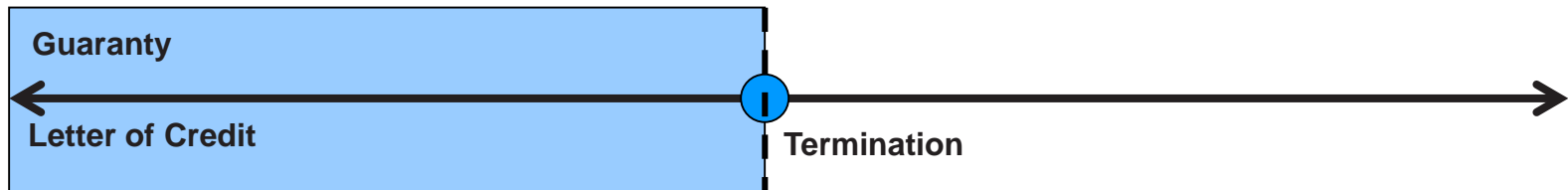
Letters of Credit

- **Advantages:**
 - Liquid
 - Simple
 - Commonly used
- **Disadvantages:**
 - For beneficiaries, risk that issuer will become insolvent
 - For issuers, payment risk if called upon to perform under letter of credit
 - For posting party, risk of expenses to replace if called upon

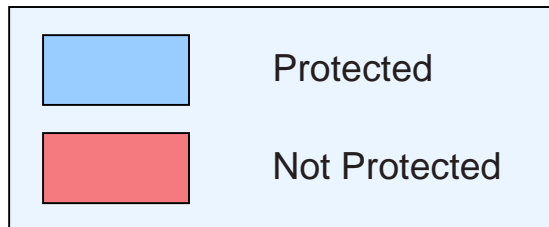
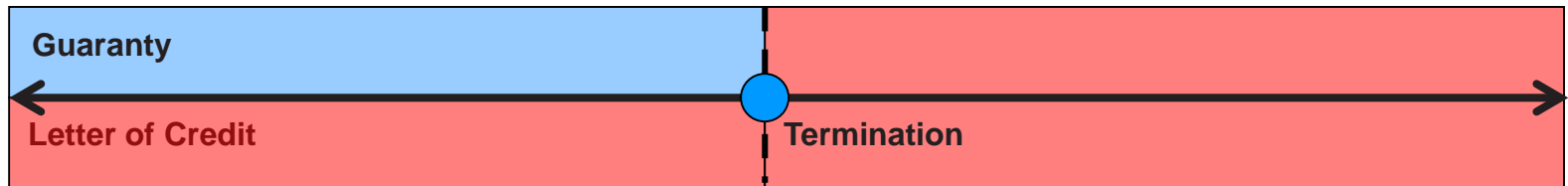
Guaranties and Letters of Credit

- Credit Protection: Guaranties v. Letters of Credit

- BEFORE TERMINATION



- AT AND AFTER TERMINATION



Roadmap Review

II. Overview and Comparison of Standard Credit Support Documentation

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- b. Adequate assurances
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Standard Credit Support Documentation – a Comparison

- Assignment and Transfer

- Is it permitted?

- Permissibility is generally determined under the relevant master agreement in each case—*i.e.*, the credit support document is silent. This generally involves written consent.
 - BUT – note that under the WSPP Agreement (the general terms), reference is made to assignment after acceptable assurances. Thus, negotiation may be *required* in certain instances.

Standard Credit Support Documentation – a Comparison

- Assignment and Transfer

- Any exceptions to the written consent requirement?
 - Again—generally determined under the relevant master agreement.
 - Written consent is not required when:
 - Transfer in connection with merger-related activity: ISDA, EEI
 - Transfer in connection with any financing or financial arrangements: NAESB, EEI
 - Affiliate transfers: NAESB, EEI
 - Transfer interest in payments or early termination payments: ISDA

Standard Credit Support Documentation – a Comparison

- Adequate Assurances

- Right granted by contract?

- If provided, terms are in the master agreements:

- ISDA: Not included, but parties frequently add language to the Schedule

- NAESB: Yes, if reasonable grounds for insecurity exist

- EEI: Yes, if elected—*by party*—and reasonable grounds that creditworthiness or performance becomes unsatisfactory

- WSPP: Yes, if creditworthiness, financial responsibility, or performance becomes unsatisfactory

Standard Credit Support Documentation – a Comparison

- Adequate Assurances

- Acceptable forms for adequate assurance
- If provided, terms are in the master agreements:
 - ISDA: Not included, but parties frequently add language to the Schedule
 - NAESB: Cash, or other form acceptable to the requesting party, including L/Cs, prepayment, lien, or guaranty
 - EEI: Cash, L/Cs, or other form acceptable to the requesting party
 - WSPP: Cash, L/Cs, guaranty, other acceptable collateral, or *mutually agreeable* form that satisfies the requesting party

Standard Credit Support Documentation – a Comparison

- Adequate Assurances

- Transfer timing

- WSPP: Negotiated and expressed in the Collateral Annex Cover Sheet

- Others: If provided, terms are in the master agreements:

- ISDA: Not included, but parties frequently add language to the Schedule

- NAESB: Between 1 business day and 48 hours after written request

- EEI: Within 3 business days of written request

Standard Credit Support Documentation – a Comparison

- Suspension Rights

- Contractual Suspension Rights and Triggering Events

- In the form of conditions precedent in the credit support documents:

- ISDA and WSPP: No event of default or potential event of default

- ISDA: No unsatisfied payment obligations related to an Early Termination Date

- In the form of events of default under the master agreements:

- NAESB: A “credit support default” has the effect of an event of default

- EEI: If determined to be a breach of a covenant or obligation, or failure to make a payment when due

Standard Credit Support Documentation – a Comparison

- Suspension Rights

- Time limitations

- Only found under the master agreements:

- ISDA: Only under a Power Annex, 10 NERC business days

- NAESB: N/A

- EEI: 10 NERC business days

- WSPP: 10 business days

Standard Credit Support Documentation – a Comparison

- Grant of Security Interest and Setoff
 - Grant of security interest
 - All generally grant a present, first-priority, continuing security interest with a right of setoff
 - Setoff
 - Generally, both pledgor and secured party may setoff under the credit support documents
 - Nuances:
 - ISDA:
 - Secured party may not setoff if pledgor has paid all obligations
 - Pledgor (i) *may not* setoff if termination relates to less than all transactions and (ii) *may* setoff *only* if secured party fails to return collateral
 - Pledgor may only setoff if secured party fails to return collateral: NAESB, EEI, and WSPP

Standard Credit Support Documentation – a Comparison

- Credit and Collateral Triggers

- Collateral Thresholds

- ISDA, EEI:

- Independent Amounts negotiated by the parties (under the EEI Collateral Annex, full or partial floating independent amounts are available)
 - Thresholds negotiated by the parties under the ISDA, no express election between a flat amount and a ratings-based matrix

- NAESB, EEI, and WSPP: Elections, by party, as to thresholds set by a (i) flat amount or (ii) ratings-based matrix

Standard Credit Support Documentation – a Comparison

- Collateral Characteristics

- Eligible Collateral

- ISDA, NAESB, EEI: Elected or negotiated on the cover sheets
 - Frequently – cash and/or L/Cs
 - Less frequently in physical energy deals – treasuries or other less-liquid securities
 - WSPP: Cash, L/C, or other security acceptable to the beneficiary party

Standard Credit Support Documentation – a Comparison

- Collateral Characteristics
 - Calculation of collateral requirement
 - ISDA:

Credit Support Amount

$$= \mathbf{max} [0 \mid \text{Secured Party's Exposure} + \text{Pledgor's Independent Amount} \\ - \text{Secured Party's Independent Amount} - \text{Pledgor's Threshold}]$$

Delivery Amount

$$= \mathbf{max} [0 \mid \text{Credit Support Amount} - \text{Value of Posted Credit Support}]$$

Return Amount

$$= \mathbf{max} [0 \mid \text{Value of Posted Credit Support} - \text{Credit Support Amount}]$$

Delivery and Return Amounts triggered if the amounts exceed the Minimum Transfer Amount

Standard Credit Support Documentation – a Comparison

- Collateral Characteristics
 - Calculation of collateral requirement
 - NAESB:

Collateral Requirement

$$= \mathbf{max} [0 \mid \text{Secured Party's Exposure} - \text{Pledgor's Threshold} \\ + \text{Value of Posted Collateral} + \text{Interest Amount untransferred}]$$

Standard Credit Support Documentation – a Comparison

- Collateral Characteristics
 - Calculation of collateral requirement
 - EEI:

Collateral Requirement

$$= \mathbf{max} [0 \mid \text{Secured Party's Net Exposure} - \text{Pledgor's Threshold} \\ + \text{value of collateral held by Secured Party} *]$$

*The value of collateral held by the Secured Party includes cash previously transferred to the Secured Party, the amount of cash held as a result of drawing on an L/C, any interest that has not been transferred, and the value of each L/C or other non-cash collateral held by the Secured Party

Standard Credit Support Documentation – a Comparison

- Collateral Characteristics
 - Calculation of collateral requirement
 - WSPP:

Collateral Requirement

= **max** [0 | *Posting Party's § 21 Termination Payment*
+ *Posting Party's damages under § 21.3*
+ *other amounts due by Posting Party for rendered performance*
– *currently posted Performance Assurance + Posting Party's Threshold*]

* § 21.3 damages relate to a failure to deliver or receive.

Standard Credit Support Documentation – a Comparison

- Collateral Characteristics

- Exposure definition

- Generally, all credit support documents describe exposure as the amount that would be payable to a party if all transactions were terminated on the calculation date.

- Nuances:

- NAESB: Calculated as the mid-point of the bid and offer prices
 - EEI: Expressly includes mark-to-market exposure in addition to amounts that are otherwise due and payable between the parties

Standard Credit Support Documentation – a Comparison

- Collateral Characteristics

- Secured party's eligibility to call for performance assurance/collateral
- ISDA, EEI, WSPP: Secured Party may demand, provided conditions precedent are satisfied (no EOD or Potential EOD, or unsatisfied payment obligations related to an Early Termination Date)
- NAESB: Two Options:
 - Option A: On the close of business on the day after the demand date
 - Option B: An agreed-upon date
 - Both Options: Subject to the conditions precedent that no Credit Support Default exists/continues, no Secured Party EOD exists/continues, no Early Termination Date with unsatisfied obligations exists as declared by the Pledging Party

Standard Credit Support Documentation – a Comparison

- Collateral Characteristics

- Eligibility of the posting party to request a reduction
 - Generally, each credit support document permits the posting party to request a return of performance assurance if the posted amount exceeds the amount required.
 - ISDA, NAESB, EEI: Subject to the conditions precedent generally applicable to requests for transfer (and discussed above)

Standard Credit Support Documentation – a Comparison

- Collateral Characteristics

- Care of performance assurance/collateral and substitutions
 - Duty of Care:
 - ISDA, NAESB, EEI: Generally must exercise reasonable care, which will be deemed reasonable if the Secured Party exercises the same level of care it would with its own property
 - WSPP: No duty of care
 - Substitutions:
 - ISDA: Must be Eligible Credit Support; may elect that Secured Party consents to the substitution
 - NAESB, EEI, WSPP: Must be of equal or greater value; if not the same form then secured party must consent to alternative

Standard Credit Support Documentation – a Comparison

- Collateral Characteristics

- Care of performance assurance/collateral and substitutions (cont.)
 - Timing of substitutions:
 - ISDA: Not later than 1 Local Business Day after the Secured Party receives the substitute credit support
 - NAESB: Two Options:
 - Option A: Close of business on the business day after the request
 - Option B: As agreed by the parties
 - EEI: Within 2 Local Business Days after the Secured Party receives the substitute performance assurance
 - WSPP: Inverted obligation – Posting Party must give notice to the Beneficiary Party no later than 5:00 PM New York time 2 business days before the substitution is to occur

Standard Credit Support Documentation – a Comparison

- Collateral Characteristics

- Margining disputes

- Time to declare a dispute:

- ISDA: Not later than the close of business on the Local Business Day after (i) the date a demand for Credit Support is made or (ii) the date of Transfer
 - NAESB: Two Options:
 - Option A: Not later than the close of business on the date demanded
 - Option B: As agreed by the parties
 - EEI: Not later than the Notification Time on the first Local Business Day after demand
 - WSPP: Not later than 4:00 PM on the date a demand is made

Standard Credit Support Documentation – a Comparison

- Collateral Characteristics

- Margining disputes (cont.)

- Disputing party to pay entire amount, or only the undisputed amount?

- Generally, the disputing party pays only the undisputed amount under all of the credit support documents
 - Nuance: Under the NAESB, the Posting Party may transfer the amount it deems appropriate according to its own calculation of the Collateral Requirement, but only *after* notice of the dispute is delivered to the other party

Standard Credit Support Documentation – a Comparison

That was a lot of “Collateral Characteristics” . . .



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Let's Shift Gears

Standard Credit Support Documentation – a Comparison

- Holding and Using Collateral

- Eligibility to hold collateral

- Generally, the eligibility to hold collateral is negotiated by the parties under the ISDA, EEI, and WSPP

- NAESB: The Secured Party (or its Custodian) may hold collateral provided:

- The Secured Party is not a Defaulting Party
 - The Secured Party (or its Credit Support Provider) and any Custodian meet the eligibility requirements set forth on the cover sheet
 - Cash may only be held in the U.S.
 - If the Secured Party is not eligible—collateral must be held with a Custodian

Standard Credit Support Documentation – a Comparison

- Holding and Using Collateral
 - Use of collateral
 - ISDA, NAESB, and EEI: Generally, the secured party may use the collateral free of any claim or right of the pledging party, including by sale, pledge, rehypothecation, assignment, investment, etc.; *provided* the secured party is not a defaulting party or an early termination date has been declared by the pledging party
 - WSPP: Use is only described with respect to cash. Cash may be sold, pledged, rehypothecated, assigned, invested, used, commingled, or used in its business; *provided* that it must be held in the U.S.

Standard Credit Support Documentation – a Comparison

- Letters of Credit

- What is a qualified institution?
 - ISDA and NAESB: Negotiated by the parties
 - EEI: Must be a major U.S. commercial bank or a U.S. branch of a foreign bank with a credit rating by S&P and Moody's (or one of them, if only rated by one) of "A-" and/or "A3".
 - WSPP: Must be a commercial bank or trust company having a capital surplus of at least \$1 billion, and a credit rating by S&P and Moody's (or one of them, if only rated by one) of "A-" and/or "A3". May also be agreed upon by the parties.

Standard Credit Support Documentation – a Comparison

- Letters of Credit
 - L/C requirements
 - ISDA and NAESB: Negotiated by the parties
 - EEI: Must be issued by a major U.S. commercial bank or a U.S. branch of a foreign bank with a credit rating by S&P and Moody's (or one of them, if only rated by one) of "A-" and/or "A3". A template is provided with the Collateral Annex
 - WSPP: Generally required to be an irrevocable, non-transferable, standby L/C in a form consistent with the parties' negotiated terms

Standard Credit Support Documentation – a Comparison

- Letters of Credit
 - Ability to draw
 - ISDA: Able to liquidate collateral generally, otherwise as negotiated by the parties
 - NAESB, EEI, and WSPP: May draw the full, undrawn face amount of the L/C, *provided* the secured party is not a defaulting party and no early termination date is declared with respect to it

Standard Credit Support Documentation – a Comparison

- Letters of Credit

- Is there an L/C default?

- ISDA: As negotiated by the parties

- NAESB, EEI, and WSPP: Includes the following:

- The issuer's failure to qualify as a qualified institution (as defined in each)

- The issuer becomes bankrupt

- The issuer fails to comply with its obligations under the L/C

- The issuer disaffirms, disclaims, repudiates, or rejects the L/C

- The L/C expires or terminates and is not replaced, or fails to be in full force or effect

Standard Credit Support Documentation – a Comparison

- Letters of Credit
 - Time period to cure an L/C default
 - ISDA: As negotiated by the parties
 - NAESB: 2 business days; if the L/C default is due to the issuer failing to meet the requirements, then 5 business days
 - EEI: 1 local business day; if the L/C default is due to the issuer failing to meet the credit rating requirements, 5 local business days
 - WSPP: 5 business days

Standard Credit Support Documentation – a Comparison

- Letters of Credit
 - Is a template form provided?
 - ISDA, WSPP: As negotiated by the parties
 - NAESB: N/A
 - EEI: Yes, on Schedule 1



Note that, while parties may negotiate the form of letter of credit prior to its issuance, issuing banks are typically reluctant to entertain customer-supplied forms (in lieu of using its own form) and such negotiation can be time-intensive and expensive.

Standard Credit Support Documentation – a Comparison

- Pledging Party's Rights

- Under all of the credit support documents and upon a secured party event of default, the pledgor may/the secured party is obligated to:
 - Exercise all rights and remedies available at law
 - Exercise all rights and remedies available under the terms of Other Posted Support/Letter of Credit
 - The secured party is obligated to immediately transfer all posted collateral and interest to the pledging party
 - If not returned, the pledgor may (i) setoff amounts payable to the secured party against any collateral still held by the secured party and (ii) to the extent not setoff, withhold payment for remaining amounts payable

Standard Credit Support Documentation – a Comparison

- Pledging Party's Rights (cont.)
 - Nuances:
 - ISDA: Pledgor may not engage in the foregoing if (i) it has declared an Early Termination Date with respect to less than all Transactions or (ii) the Secured Party has paid in full all of its obligations that are due under the Early Termination provisions of the ISDA

Standard Credit Support Documentation – a Comparison

- Miscellaneous

- Pledging party representations

Rep	ISDA	NAESB	EEI	WSPP
Power to grant the SI	X	X		
Sole owner of the collateral/transfer free and clear	X	X	X	X
Valid and perfected 1 st priority SI after transfer	X	X	X	
Performance creates no other liens	X	X	X	
Enforceability of L/C against issuer		X		
No other agreements restricting rights in the collateral			X	X
No gov't approval necessary to grant the SI				X



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