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Terminating a long term gas sales contract on account of a material adverse change: the continuing fallout from the collapse of the Enron Empire

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Cases Considered:

Marathon Canada Ltd v. Enron Canada Ltd, 2008 ABQB 408;
Marathon Canada Ltd v. Enron Canada Ltd, 2009 ABCA 31.

The Court of Appeal, in a memorandum of judgement authored by Justices Ellen Picard, Peter Costigan and Jack Watson, has affirmed the decision at trial of Justice Terence McMahon of the Alberta Court of Queen's Bench. Justice McMahon held that Marathon Canada had lawfully terminated a natural gas purchase contract with Enron Canada. Marathon chose to terminate when Enron Canada's US parent (Enron Corp) fell into serious financial difficulties. Both courts also held that: (1) Marathon was entitled to recover $560,000 damages for natural gas that it had delivered prior to contract termination, but that, (2) Enron Canada was not entitled to recover liquidated damages of some $126 million based on a counter-claim of wrongful termination and the estimated\guesstimated present value of Marathon's future deliveries at the contract price.

It should be apparent from the size of Enron's damages claim that at the time that Marathon purported to terminate the contract, Marathon was "out of the money" on its contract with Enron; i.e. market prices were above prices provided for in the contract and thus Marathon, but for being able to lawfully terminate the contract, would have been obliged to continue to deliver gas to Enron at a contract price that was lower than the market price. Alternatively, Marathon could have cashed out, but in such a case it would have had to have paid the present value of the outstanding deliveries. In sum, by taking advantage of the termination trigger in the contract Marathon was able to secure for itself a significant windfall since it could now take the gas that had been formerly committed to Enron and sell it into the (higher) market.

This was a particularly bitter pill for Enron Canada to swallow, for while Enron Corporation was obviously in financial difficulty, Enron Canada, the "jewel of the Enron Empire" was in no such difficulty, except to the extent that it was vulnerable (and the extent to which this was actually the case is unclear - see para 37 at trial) to Enron Corporation making calls on Enron Canada's funds.

The facts

Marathon (M) and Enron Canada (EC) were parties to a master natural gas purchase contract of

1995 with EC as purchaser and M as seller. EC was an indirect subsidiary of Enron Corp., a US company which guaranteed EC's obligations up to $10 million. The master agreement anticipated that the parties would enter into confirmation agreements from time to time specifying details of each transaction. There was one relevant agreement for the period April 1995 - November 2012 which called for the delivery 7,500 MMBtu's per day for a fixed escalating price.

Under the agreement, each party had the right to terminate on two days notice after a "triggering event". The triggering event clause is a complex clause but the court only quotes one such triggering event which is (para. 9.3(h)) "the occurrence, in the reasonable opinion" of the notifying party of a "material adverse change" ("MAC") of the other party. This clause provides that an event would not be a triggering event where, *inter alia*, a party established and maintained a letter of credit in the defined amount. No such letter of credit was ever maintained. A material adverse change in the case of EC meant a situation where "Enron Corp. shall have long-term debt unsupported by third party credit enhancement that is rated by Standard and Poors below BBB-".

Enron Corp ran into financial difficulties in the fall of 2001 and by November 28, 2001 S & P had reclassified Enron Corp's credit rating to B-. As soon as M heard this news it faxed Enron Canada alleging a MAC and also purporting to give notice of termination effective December 1, 2001.

Enron Canada was not in any particular difficulty at the time. It would have had the ability to post security if demanded but Enron Corp could and did withdraw money from EC's accounts until EC put a stop to this in November 2001, EC's continuing ability to do so was unclear.

Marathon commenced this action claiming $560,000 for gas deliveries for November 2001 for which it was not paid. Enron Canada counterclaimed on the basis that Marathon had improperly terminated the agreement and seeking damages of $126 million based on the liquidated damages clauses of the agreement and the costs of purchasing replacement gas. Enron Canada argued that industry practice required that M give notice requiring EC to provide performance assurance (e.g. posting a letter of credit or cash) and then giving EC a reasonable time (three to ten days) to perform before the right to early termination arose.

The trial decision

Justice McMahon at trial held that M lawfully terminated the agreement and was entitled to damages. Enron Canada's counterclaim was dismissed.

M had formed a reasonable opinion of a material adverse change in Enron Corp.'s status. The agreement chose to measure EC's ability to perform by reference to Enron Corp.

The evidence did not establish an industry practice of notice and opportunity to provide assurance of ability to perform before terminating. In any event, such a practice runs contrary to the plain language of the agreement. Even if industry practice had evolved (as evidenced by other standard forms such as that of the Gas Industry Standard Board (trial at para. 123)), that practice should have been incorporated by an amendment to the agreement. Certainty of terms is essential to derivatives trading and certainty is best achieved by unambiguous contract language rather than by superimposing on contract language evidence of industry "expectations".

The duty of good faith (trial at paras 128 - 131) may be relevant to the proper interpretation of a contract but Canadian law does not recognize a free standing duty of good faith independent of the terms of the contract. The exercise of a contractual right of termination is not evidence of breach of good faith. Neither was there unjust enrichment since there was a juristic reason for the enrichment.

There are one and two way gas purchase contracts (trial at para 21). In a two way contract, termination for whatever reason requires that the party who is "out of the money" pay the party who is "in the money" the present value of undelivered gas over the balance of the contract. In the case of a one way contract, the party who is out of the money only pays if it is in default. In this case, M was out of the money in the tens of millions of dollars. While the evidence suggested that there was a trend to adopt two way contracts rather than one way contracts this contract was a one way contract since it only contemplated assessing the damages (if any) incurred by the non-defaulting party (trial at paras 148 - 165). Since the court had already found that M was not in default that was the end of the matter.

Enforcement of a specific provision in a contract could not be a penalty and this was therefore not a case in which EC could seek relief from forfeiture (or a penalty). But even if it were, this was not an appropriate case for relief from forfeiture. The parties had expressly contracted for a one way clause which, depending on the circumstances, might benefit either party. It would be unfair and inequitable to deny enforcement of such a provision. This was not a case of unconscionability or unequal bargaining power (trial at paras 166 - 173).

In the event that it was necessary to establish EC's damages the parties faced the difficulty that they could not comply with the method of calculating damages stipulated by the contract which was to obtain quotes of future prices (at paras 179 & 185). In the absence of that it was not unreasonable to use actual Nymex data until the date of trial. On a forward basis it was unreasonable simply to project out linear price increases until the end of the term of the contract and it was therefore preferable to determine damages based on a Kalman filter model (discussed at trial at paras 59 - 79 and at 179 - 184).

The appeal decision

The Court of Appeal in a relatively short memorandum of judgement has affirmed. The Court of Appeal held that the standard of review would be correctness insofar as the issues raised were pure questions of contractual interpretation but that the standard would move to the significantly more deferential "palpable and overriding error" standard insofar as the issues became muddied (my word not the Court's) with issues and evidence as to industry custom and practice and commercial context.

The main issue addressed by the Court of Appeal was the argument that the written terms of the contract needed to be qualified by an understanding of a practice or custom in the industry, according to which Marathon would not be able to terminate unless and until it had accorded Enron a reasonable amount of time to post alternative security for its performance of the contract. The Court of Appeal concluded that this was little more than "an attempt to rewrite the plain terms of the Agreement" (at para. 13). And given that this was not a case of ambiguity and given that "the rules for implying terms into a contract are strict and do not favour contradicting the contract's express terms" (*id*) the Court had little difficulty in concluding that the trial judge did not make a palpable and overriding error.

Comment

From one perspective there is nothing very remarkable about the approach taken by both Courts in this decision if the contract were as clear as the Courts suggest. It seems reasonable to conclude that this was a commercial contract (largely drafted by Enron - although s.15.10 (para 20 of the trial judgement) does acknowledge that both parties prepared the contract and that it should not be construed against either by reason of its preparation) between sophisticated parties and that there is therefore little room to imply additional terms into such a contract. This seems especially to be the case when there were so many different ways of framing the precondition to utilizing the early termination provision of the Agreement.

In sum, according to this view, if Enron Canada had wanted a situation in which: (1) it was Enron's Canada's credit rating that was crucial to a determination of "material adverse change" rather than that of Enron Corp, (2) either party was required to allow the other to post security to cure an MAC, and (3) the party that was out of the money was required to pay the present value of the balance of the contract regardless of the cause of termination, then Enron Canada was perfectly able to contract for any or all of these entitlements. On a plain reading the contract did not provide for any of these.

But another view emerges if one examines the entirety of the crucial Article 9 (Defaults and Remedies) of the contract. That article provides (as noted above) that a party may serve notice to terminate if there is a triggering event. If there is no triggering event there can be no notice to terminate. The article goes on to define ten (10) forms of triggering event. The crucial point about those 10 individual paragraphs is that while one might expect triggering events to be bright line events, some of the paragraphs undoubtedly contain internal curing provisions which presumably must run their course before one can decide that a triggering event has occurred. For example, s. 9.3(a) provides that a triggering event includes the failure of an affected part to make a required payment. However, the trigger only applies if the failure is not remedied within five days of written notice and the clause is subject to the further proviso that the payment is not the subject of good faith dispute. In sum, a failure to make a payment is not itself a triggering event. It will only be a triggering event if: (1) the affected party fails to remedy and (2) if the payment is not itself the subject of a dispute.

The conditional nature of the trigger in this clause 9.3(a) (also evidenced in some of the balance of the list of ten triggering events) at the very least makes it easier to appreciate why the MAC triggering event might also be read as conditional (and curable) rather than simply self-executing. The relevant text of the MAC clause (and Justice McMahon quotes this part of the clause at para 16)) read as follows:

> 9.3. Triggering Event shall mean with respect to a Party (the "Affected Party"):
> (h) the occurrence, in the reasonable opinion of the Notifying Party, of a Material Adverse Change of the Affected Party; provided that such Material Adverse Change shall not be considered to be a Triggering Event if the Affected Party establishes, and maintains throughout the term hereof, a Letter of Credit (naming the Notifying Party as the beneficiary thereof) in an amount equal to the greater of (i)the Notifying

Party's Liquidated Damages or (ii)if the Notifying Party is the Seller, the aggregate of the amounts Seller is entitled to receive during the sixty-Day period preceding the Material Adverse Change. The amount of such Letter of Credit shall be adjusted quarterly if necessary, to cover the Notifying Party's Liquidated Damages at that point in time (emphasis supplied)

The structure of the clause is to provide that a MAC will be a triggering event. But that statement is immediately qualified by the proviso which tells us that a MAC will not be a triggering event in certain circumstances. As any oil and gas lawyer who reads provisos to habendums of leases knows a proviso can serve to re-define relevant terms. The question therefore is not so much "is there a custom in the industry that is inconsistent with the plain meaning of the clause" (a tough hurdle to meet) so much as "what is reasonable commercial interpretation of this paragraph within the context of a whole series of defined triggering events."

In short, this case was perhaps not as clear a case as it seems when one reads the limited extracts from the contract provided by the Court. A more contextualized interpretation of the relevant clauses (and that's what we should be doing - reading the entire contract) calls this into question. The difficulty of course is that the reader has to acquire the contract itself to fully appreciate the more contextualized approach. Absent that it looks like a no-brainer.

Additional note

In a judgement reported as 2008 ABCA 424 Justice Myrna Paperny denied Marathon's application that Enron be required to provide security for the trial costs (estimated at some $3.5 million). Justice Paperny, applying Rule 524 (which makes it clear that security will not be required except in exceptional circumstances), concluded that Marathon had not made out its case. The fact that Enron Canada was undergoing voluntary liquidation was not a special circumstance in this case. In any event, Marathon had delayed unreasonably in seeking security.