Eligible Financial Contracts
in Canadian Insolvency Regimes

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Executive Summary

This paper will review the legislative history of the provisions in Canadian insolvency legislation (specifically the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*) affecting what are referred to as eligible financial contracts and consist of various over-the-counter derivatives contracts. The way the legislation has been applied in the three cases (at both the trial and appellate levels) that have considered these provisions will be reviewed as well as the provisions that have received Royal Assent as part of *An Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts,* S.C. 2005, c. 47 (which will be referred to throughout as "Chapter 47"), but have not yet been proclaimed in force. The similar provisions contained in Chapter 11 of the United States Code (dealing with bankruptcy and insolvency) will be reviewed as well as recent case law applying these provisions.

The form of Master Agreement published by the International Swaps and Derivatives Association, Inc. will be reviewed as this is the form of agreement commonly used to document derivatives transactions. Specifically, the choice of law provisions, default clauses regarding bankruptcy events and the netting and set-off provisions, which are of particular interest and concern in the case of an insolvency, will be analyzed.

Finally, the United States approach will be compared and contrasted to the approach that has been taken in Canada. Areas where change may be appropriate and areas where the current or proposed legislation show cause for concern will be discussed.

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1 Introduction

Agreements that are referred to in Canadian bankruptcy and insolvency legislation as "eligible financial contracts" are risk management tools. They are "investment tools whose value depends on, or is derived from the performance of some underlying asset such as stocks, bonds, commodities, currencies or indices"[1]. It is for this reason that special treatment is afforded to them. One party (the seller) agrees to sell a commodity at a set price sometime in the future (the short position) predicting that the price of the commodity will decline such that on the delivery date, that seller party will sell the commodity at a price greater than the current market price. The purchaser party will take the long position in agreeing to purchase the commodity. The purchaser party assumes the risk of price fluctuations and assumes that the market price for the commodity will increase such that it will purchase the commodity at a future date for a price lower than the market price.

In order to further hedge their risk, parties will enter into various purchase agreements providing for the sale of the commodity at different dates and at different prices. Throughout the term of any of these agreements some of them will be "in the money" (i.e. for the seller this means the contract provides for sale at a price higher than the market price) and others will be "out of the money" (i.e. again from the seller's perspective, the market price is lower than the contract price). Each of these transactions can be netted out or set-off against the others on termination and the purchaser can "calculate the value of all the transactions as of the termination date and … net the

[1] G. Luinenburg and F. Soda, *The Enforceability of Over-the-Counter Derivative Contracts Under Canadian Insolvency Regimes*, (1996) 12 B.F.L.R. 41 at 43.

positive and negative values to determine a lump sum termination amount payable by one party to the other"[2]. Each party attempts, through hedging these various contracts against one another, to profit from the transactions.

As derivatives contracts have become more common and more widespread as a method of managing risk, the importance that they are treated consistently has increased. In 1994, Confederation Treasury Services Ltd. was placed under CCAA protection. In the initial order granted by Justice Houlden, Confederation was given the ability to terminate "out of the money" contracts and to preserve "in the money" contracts. This order was at issue in *Confederation Treasury Services Ltd. (Trustee of)* v. *Hees International Bancorp Inc.*[3], a case looking at whether Confederation had properly terminated certain derivatives contracts. In the decision in that case, Justice Farley took the opportunity to make the following observations with respect to derivatives contracts generally:

> [i]t would seem as a matter of public policy that such a valuable tool which has become a key fundamental for the interlocking financial activities of virtually every major financial and many major non-financial corporations in Canada (and having international links) should not be dealt with in such a manner as to seriously affect its efficiency. Not only is this the situation in non-insolvency situations but as well it is in insolvency situations as Anthony C. Gooch and Linda G. Klein, *A Review of International and U.S. Case Law Affecting Swaps and Related Derivative Products*, August 1, 1992 stated at pp. 38-9:
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> > If the right to terminate contemplated in the agreement, or the selected measure of damages upon early termination, is not enforceable, the whole structure of risk management for the swaps and other transactions is weakened or may fall apart.

[2] M.E. Grottenhaler and P.J. Henderson, *The Law of Financial Derivatives in Canada*, (Toronto: Carswell, 1999) ("*Financial Derivatives*") at 5-1.
[3] [1997] O.J. No. 351 (Ont. Gen. Div.) (QL).

> …
>
> In swap documentation, the occurrence of bankruptcy, insolvency or a similar event with respect to a party has usually been treated as an event of deault [sic] with respect to that party and, moreover, at least until recently, as an event that led to immediate and automatic termination of that party's swap transactions. There have, however, been serious doubts as to the enforceability of this provision in some jurisdictions, and concerns about the potentially adverse effects that automatic termination could have on a non-defaulting party. In the United States, many of the doubts have now been resolved by legislation[4].

Eligible financial contracts are referred to in the *Winding-Up and Restructuring Act*[5] as well as the *Companies' Creditors Arrangement Act*[6] and Part III of the *Bankruptcy and Insolvency Act*[7] dealing with proposals. Due to the limited applicability of the *Winding-up and Restructuring Act*, only those provisions in the BIA and the CCAA will be discussed in this paper.

2 Legislative History

Prior to 1992, there were no provisions in either the *Companies' Creditors Arrangement Act* or the *Bankruptcy and Insolvency Act* dealing with what are now commonly referred to in Canada as eligible financial contracts ("EFCs"). In 1991, as part of an overhaul of the former *Bankruptcy Act*, the House of Commons Standing Committee on Consumer and Corporate Affairs and Government Operations heard testimony from the Canadian Bankers' Association with respect to recent amendments to the United States Bankruptcy

[4] *Ibid* at para 48. The initial order of Justice Houlden and the decision of Justice Farley were both after the amendments to the BIA to provide protection for EFCs were in force, but before the similar amendments to the CCAA were made.
[5] R.S.C. 1985, c. W-11, s. 22.1(2).
[6] R.S.C. 1985, c. C-36 (the "CCAA"), s. 11.1.
[7] R.S.C. 1985, c. B-3 (the "BIA"), s. 65.1.

Code that incorporated an exemption from the stay of proceedings for counterparties to certain types of contracts.

Bill C-22 as originally drafted included a provision to prohibit creditors from terminating agreements with debtors from the time a notice of intention to file a proposal is filed and continuing throughout the stay period. The Canadian Bankers' Association submitted that financial hedging agreements be exempt from this stay of proceedings. The following statements from their submissions to the Parliamentary Committee are often cited:

> [a] very important issue relating to commercial insolvencies is the status of financial hedging contracts in these insolvencies. We realize that this may appear to be a fairly technical issue to members of this committee. We want to assure you that this is of vital concern to the financial community as a whole, not just ourselves. …
>
> A recent amendment to Chapter 11 of the US Code does permit counter-parties to terminate or close out hedging contracts during a stay period if one of these parties becomes insolvent. Similar legislation we feel is needed in Canada to ensure the continued competitiveness of Canadian financial markets and their ability to be part of these contracts when the other party is in fact a US entity or a US citizen[8].

The Canadian Bankers' Association described these agreements in its brief to the House of Commons Committee as follows:

> [f]inancial hedging agreements are important tools used by financial managers to reduce a variety of financial risks. They consist of

[8] Minutes of Proceedings and Evidence of the Standing Committee on Consumer and Corporate Affairs and Government Operations, September 11, 1991, p. 12:7.

> sophisticated off-balance sheet instruments ranging from foreign exchange contracts to interest rate and currency swaps.
>
> If a counterparty to a financial hedging agreement becomes insolvent, significant uncertainties will exist among other counterparties about the amount of their exposure to the counterparty. Because financial markets can change significantly in a matter of days, or even hours, a party to a financial transaction with an insolvent counterparty could face heavy losses unless the transaction is resolved promptly and with finality[9].

In their oral submissions, the representative for the Canadian Bankers' Association went on to say:

> [t]he contracts being discussed, which we have called eligible financial contracts, are, however important in their limited sphere. They help Canadian and other corporations world wide to manage risks such as changes in interest rates and in currency exchange rates.
>
> In the United States the solution we propose has been adopted, as an exception to their very pro-debtor legislation. It has enabled troubled US debtors, and especially those in the financial community, to continue to be able to access these risk controlling markets at a time when they have needed such protection the most[10].

The effect of the change is not to favour either the debtor or the counterparty to these transactions, but to allow the rights of each party to be calculated (pursuant with the contract) and reduced to a certain amount as of the date of termination. This allows the solvent party to go back into the marketplace to re-hedge its position. The proposals of

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[9] Canadian Bankers' Association, *Insolvency Law Reform in Canada: CBA Comments on Bill C-22*, A Submission to the House of Commons Consumer and Corporate Affairs Committee, September 1991.

[10] Minutes of Proceedings and Evidence of the Standing Committee on Consumer and Corporate Affairs and Government Operations, September 11, 1991, p. 12:28.

the Canadian Bankers' Association were accepted by the House of Commons committee and the resulting amendment to Part III of the BIA, dealing with proposals, exempts EFCs from the breadth of the stay of proceedings.

In 1996, Parliament considered changes to the CCAA, which came into effect in 1997, and, as part of this endeavour, imported the BIA protection for EFCs into the CCAA. The main thrust of the legislative intent in making this change was to harmonize the CCAA with the BIA proposal provisions. There is very little discussion of this amendment in the Parliamentary Committee minutes of proceedings. It would appear, based on the fact that no changes were made to the wording of the section prior to its inclusion in the CCAA and that the section in the BIA had not yet been tested in the courts, that the legislators did not have any other purpose in its inclusion. It would also appear that little thought, if any, was given to whether or not there were possible amendments that could be made to the section as it then appeared in the BIA. The relevant provisions in the CCAA read as follows:

> 11.1(1) In this section, "eligible financial contract" means
>
> (a) a currency or interest rate swap agreement,
> (b) a basis swap agreement,
> (c) a spot, future, forward or other foreign exchange agreement,
> (d) a cap, collar or floor transaction,
> (e) a commodity swap,
> (f) a forward rate agreement,
> (g) a repurchase or reverse repurchase agreement,
> (h) a spot, future, forward or other commodity contract,
> (i) an agreement to buy, sell, borrow or lend securities, to clear or settle securities transactions or to act as a depository for securities,

(j) any derivative, combination or option in respect of, or agreement similar to, an agreement or contract referred to in paragraphs (a) to (i),

(k) any master agreement in respect of any agreement or contract referred to in paragraphs (a) to (j),

(l) any master agreement in respect of a master agreement referred to in paragraph (k),

(m) a guarantee of the liabilities under an agreement or contract referred to in paragraphs (a) to (l), or

(n) any agreement of a kind prescribed;

"net termination value" means the net amount obtained after setting off the mutual obligations between the parties to an eligible financial contract in accordance with its provisions.

(2) No stay, etc., in certain cases. – No order may be made under this Act staying or restraining the exercise of any right to terminate, amend or claim any accelerated payment under an eligible financial contract or preventing a member of the Canadian Payments Association established by the *Canadian Payments Act* from ceasing to act as a clearing agent or group clearer for a company in accordance with that Act and the by-laws and rules of that Association.

(3) Existing eligible financial contracts. – For greater certainty, where an eligible financial contract entered into before an order is made under section 11 is terminated on or after the date of the order, the setting off of obligations between the company and the other parties to the eligible financial contract, in accordance with its provisions, is permitted, and if net termination values determined in accordance with the eligible financial contract are owed by the company to another party to the eligible financial contract, that other party shall be deemed to be a creditor of the company with a claim against the company in respect of the net termination values.[11]

[11] CCAA, *supra* note 6. The provisions found in s. 65.1 of the BIA are substantively identical to those found in the CCAA.

Through this definition, Parliament has included each of the basic types of derivatives contracts. It has also recognized that the derivatives market is always changing and has left room for various other permutations that the market may create through paragraph (j), above, which includes any combination of the other listed types of agreements or agreement similar in nature to the others specifically listed in the section. The effect of these provisions when taken together is to allow a determination of the net termination value on the closing out of an EFC. Where the debtor owes money to the solvent counterparty, this amount becomes a claim of the counterparty in the bankrupt estate[12].

Although there is no automatic stay of proceedings that results when parties seek protection under the CCAA, section 11(3) provides that the court may "make an order on such terms as it may impose" on the initial application so long as the effective period of the order does not exceed 30 days. An initial order will typically include a paragraph staying actions against the debtor and restraining creditors from "accelerating, terminating, suspending, modifying or cancelling any such agreement … exercising any rights of distress, rescission or set-off or consolidation of accounts in relation to any indebtedness or obligation"[13]. This is the stay of proceedings that counterparties to EFCs generally seek to avoid in CCAA proceedings.

Parliament did not adopt the conceptual underpinnings of the United States' amendments. As will be discussed further, this is an area of concern in the Canadian approach and could be improved through legislative amendments. The Canadian legislation sets out a

[12] BIA, *supra* note 7, s. 65.1(9).
[13] Order of LoVecchio J granted March 2, 1999, para. 3(b) in the *Blue Range Resource Corp*. CCAA proceeding.

list of agreements that should be considered EFCs, but does not include any limitations on individuals who may be entitled to protection. It also does not give any direction as to what types of agreements may be included in the terms it has used. Some consider this a benefit of the Canadian system in that it allows optimum judicial discretion in determining what will or will not be included in the exception for EFCs and others view it as a weakness because of the uncertainty that comes from applying to the court for a determination whenever there is a question as to whether a particular contract is an EFC or not. There is also an inherent weakness in that the judiciary has little to refer to in coming to a conclusion as to the intent of Parliament in drafting these exceptions.

It is important to note that there are no provisions granting special treatment to EFCs in the liquidation procedures under the BIA. There is also no explanation or reasoning for this omission. While some commentators may take the position that a stay of proceedings in a liquidation will not prevent the automatic termination of outstanding transactions under a derivatives contract and the closing-out of that agreement, this may not be the case.

Prior to the inclusion of the EFC provisions in the CCAA, the prevailing wisdom regarding treatment of EFCs under the CCAA was that the stay would not prevent termination of these types of agreements (despite the fact that the legislation contained no specific protections). However, Justice Houlden in CCAA proceedings involving Confederation Life Insurance Company, referred to above, surprised practitioners when he granted an initial order in that case allowing the debtor company to “cherry pick” its derivatives contracts. As the CCAA is not a liquidation statute, but one intended for reorganization (despite the fact that liquidations have been carried out under it), it can be said that there are no provisions in Canadian law for a company seeking to liquidate that would give protection to EFCs. This could prove unfair to counterparties in a liquidation where the debtor company seeks to assign valuable EFCs that counterparties would prefer to terminate.

In order to eliminate uncertainty in this context, the liquidation provisions of the BIA should be amended to provide specific reference to the special treatment afforded EFCs. The provisions with regard to EFCs in a liquidation should be the same as those found in Part III of the BIA.

3 Application and Interpretation

3.1 Definition of Eligible Financial Contracts

An EFC is any contract that is listed in the definition contained in s.65.1(8) of the BIA or s.11.1(1) of the CCAA[14]. Looking to the language of these sections, one can see that the definition is intended to address derivative instruments and that the purpose of Parliament must have been to give protection to the derivatives market that is not available to all parties who have entered into contracts with an insolvent[15]. Derivatives are financial instruments where each party agrees to make payments or delivery based on the performance of obligations or the change in value of an underlying interest[16]. The value of the derivative is derived solely from the price of the underlying interest. Derivatives

[14] See the text of the legislation set out in section 2 above.
[15] *Re Blue Range Resource Corp.*, [2000] A.J. No. 1032 (C.A.) (QL) ("Blue Range – C.A.") at para. 31.
[16] *Financial Derivatives*, *supra* note 2 at 1-3.

commonly possess the following attributes: they involve two parties; they include a series of rights and obligations; they last for a limited term (days or years); and they contain the option of having a margin or transfer of collateral (generally based on periodic mark-to-market[17] valuations of all transactions between the parties subject to a master agreement)[18]. The two main reasons for entering into derivatives transactions are to speculate on the movement of an underlying rate or index and to hedge a financial risk faced by the party[19].

A swap[20] is "a privately negotiated contract that requires the parties to exchange (or 'swap') specified cash flows at specified periods"[21] ending at a defined maturity date. The cash flows are not typically exchanged in actuality, but are calculated to determine which party is "in the money" and which is "out of the money". Title 11 of the United States Code[22] defines a swap agreement as:

> (i) any agreement, …, which is
>
> (I) an interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap and basis swap;
>
> (II) a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange or precious metals agreement;
>
> (III) a currency swap, option, future, or forward agreement;
>
> (IV) an equity index or equity swap, option, future, or forward agreement;
>
> (V) a debt index or debt swap, option, future, or forward agreement;

[17] This is the process of comparing contract prices to market prices to determine whether the contract has a positive or negative value with regard to one party at any given time.
[18] M. Mercier, *A New Era in Derivatives*, May 12, 2004 [unpublished].
[19] *Financial Derivatives*, *supra* note 2 at 1-8.
[20] Referred to in paragraphs 11.1(1)(a), (b), and (e) of the CCAA.
[21] *Financial Derivatives*, *supra* note 2 at 1-5.
[22] 11 U.S.C. §101, *et. seq.* (2006) (the "U.S. Code"). All references refer to title 11 of the United States Code.

(VI) a total return, credit spread or credit swap, option, future, or forward agreement;

(VII) a commodity index or a commodity swap, option, future, or forward agreement; or

(VIII) a weather swap, weather derivative, or weather option;

(ii) any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that

(I) is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap markets …; and

(II) is a forward, swap, future, or option on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value;

(iii) any combination of agreements or transactions referred to in this subparagraph;

(iv) any option to enter into an agreement or transaction referred to in this subparagraph;

(v) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), or (iv), … ; or

(vi) any security agreement or arrangement or other credit enhancement related to any agreements or transactions referred to in clause (i) through (v) …[23]

It would appear that the Canadian legislation intends to include all of these types of agreements, but our provision is much less detailed.

Forwards[24] are contracts which require a party to buy an asset from another party at a specified future date. These are typically used in the commodities, currencies, interest

[23] 11 U.S.C. §101(53B) (2006).

rates and equities markets[25]. As "forward commodity contracts" (in s. 11.1(h)) are the only EFCs that have been the subject of judicial opinion, they will be discussed extensively throughout this paper. Forward contracts are defined in the U.S. Code as:

> (A) a contract (other than a commodity contract) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase transaction, reverse repurchase transaction, consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any similar agreement;
>
> (B) any combination of agreements or transactions referred to in subparagraphs (A) and (C);
>
> (C) any option to enter into an agreement or transaction referred to in subparagraph (A) or (B);
>
> (D) a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), or (C), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a forward contract under this paragraph, except that such master agreement shall be considered to be a forward contract under this paragraph only with respect to each agreement or transaction under such master agreement that is referred to in subparagraph (A), (B), or (C); or
>
> (E) any security agreement or arrangement, or other credit enhancement related to any agreement or transaction referred to in subparagraph (A), (B), (C), or (D), including any guarantee or reimbursement obligation by or to a forward contract merchant or financial participant in connection

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[24] Referred to in paragraphs 11.1(1)(c), (f), and (h) of the CCAA.
[25] *Financial Derivatives*, *supra* note 2 at 1-5.

> with any agreement or transaction referred to in any such subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562[26].

A repurchase agreement is one in which one party agrees to sell securities through a counterparty who then sells them to another party and agrees at the same time to repurchase the securities from the original seller at a future date. A reverse repurchase is the opposite transaction and dealers manage risk through using these two types of transactions in tandem. The U.S. Code defines these as:

> … (i) an agreement, …, which provides for the transfer of one or more certificates of deposit, mortgage related securities …, mortgage loans, interests in mortgage related securities or mortgage loans, eligible bankers' acceptances, qualified foreign government securities …, or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds of the transferee of such certificates of deposit, eligible bankers' acceptances, securities, mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptance, securities, mortgage loans, or interests of the kind described in this clause, at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds;
>
> (ii) any combination of agreements or transactions referred to in clauses (i) and (iii);
>
> (iii) an option to enter into an agreement or transaction referred to in clause (i) or (ii);
>
> (iv) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), or (iii), …; or

[26] 11 U.S.C. § 101(25) (2006).

> (v) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in clause (i), (ii), (iii), or (iv), …[27]

Again, it would appear that the Canadian legislation intends to include all the variations of agreement outlined above. While it is not necessary to include such level of detail, the benefit to having a more fulsome definition in the Canadian legislation may be to lend assistance to the judiciary and CCAA/BIA participants in determining whether their specific agreements are the kind intended by Parliament to be included in the exception.

Cap, collar and floor transactions are included in the U.S. Code definition of a swap agreement. Briefly, a cap transaction is one in which:

> one party pays a single or periodic fixed amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified floating rate (in the case of an interest rate cap) or commodity price (in the case of a commodity cap) in each case that is reset periodically over a specified per annum rate (in the case of an interest rate cap) or commodity price (in the case of a commodity cap)[28].

A floor transaction is the opposite of a cap and a collar transaction is a combination of both types of agreements.

3.2 Canadian Case Law

3.2.1 Blue Range Resource Corp. – Queen's Bench

In 1999, the new EFC provisions were put to the test for the first time as part of the CCAA proceedings of Blue Range Resource Corp. in Alberta. Blue Range was a natural

[27] 11 U.S.C. § 101(47) (2006).

[28] Definitions used by ISDA of types of derivatives transactions under the ISDA Master Agreement. www.isda.org.

gas producer and marketer that had filed for protection under the CCAA in early 1999. Following the grant of the stay of proceedings, Enron Trade & Capital Resources Canada Corp petitioned the Alberta Court of Queen's Bench for a declaration that two of its contracts with Blue Range were EFCs under the CCAA and, as such, exempt from the stay of proceedings. Two other companies, Engage Energy Canada, L.P. and Duke Energy Marketing Limited Partnership, joined in the proceeding. In his reasoning, Justice LoVecchio determined that the master firm agreements with Enron and the agreements with each of Engage and Duke were not EFCs.

Justice LoVecchio struggled with the appropriate definition of a "forward, future or other commodity contract" listed in paragraph 11.1(1)(h) of the CCAA and noted that the statute did not provide assistance in this regard. The monitor and the secured creditor of Blue Range argued that the relevant contracts were not EFCs as this would mean that virtually "any contract which involved the future sale of a commodity would be an 'eligible financial contract'"[29]. This was of particular concern with respect to a debtor such as Blue Range that entered into contracts with various parties for substantially all of its production.

Justice LoVecchio determined that in order to come to a conclusion as to whether these contracts were included within the exception for EFCs set out in the CCAA, he must decide whether they were financial in nature or simply supply contracts. He came to the conclusion that these contracts were not EFCs by using a distinction between contracts with "physical" and "financial" purposes. As part of his analysis, Justice LoVecchio

[29] *Re Blue Range Resource Corp.*, [1999] A.J. No. 830 (Q.B.) (QL) ("Blue Range – Q.B.").

looked at the agreements entered into and documented by the ISDA form of master agreement and agreed that these contracts are EFCs as they were financial in nature. However, although the master firm agreements were similar in nature to the ISDA Master Agreement, he determined, since the contracts contemplated the physical delivery of gas (i.e. the preamble to the agreements referred to the delivery and receipt of natural gas), they must be mere supply contracts and could not be within the intention of Parliament in its drafting of section 11.1.

Even where the transactions at issue were entered into under the guise of an ISDA Master Agreement, however, Justice LoVecchio found that they did not qualify as EFCs where the specific transaction was physical in nature. He concluded:

> [t]he intent of the legislature was only to protect those future, forward or other commodity contracts which are financial in nature and these are not such contracts. This is because the intent of the parties when the Master Firm Agreements were made was that they would be primarily "physical" contracts[30].

Justice LoVecchio had some difficulty with a difference between the Canadian approach to EFCs and the U.S. approach to forward commodity contracts – the fact that the U.S. law only protects those contracts with "forward commodity merchants". After reviewing an opinion by Kenneth Raisler (a partner at Sullivan & Cromwell, New York), Justice LoVecchio noted:

> … Mr. Raisler says "[W]hen an intermediary deals in the commodity primarily for financial and risk shifting purposes, and not primarily to arrange for the sale or purchase of the commodity as a purchaser or end-

[30] *Ibid* at para. 56.

> user, it should be considered a "forward contract merchant". The otherwise qualifying contracts it enters into for these purposes should be considered "forward contracts" as defined in the [U.S. Code] and such contracts should not be considered to be the type of "ordinary supply contracts" referred to in the legislative history".
>
> I note that [Raisler's] definition is predicated upon the purpose of the contract. It also appears to me that [Raisler's] conclusion that the Master Firm Agreements would be entitled to protection as "forward contracts" under the [U.S. Code] is based at least in part upon Enron being a "forward contract merchant" so that what might be "otherwise supply contracts" are protected because they are entered into with a "forward contract merchant" (read Enron).
>
> All of this simply reinforces in my mind that the [U.S. Code] provisions have a level of sophistication and detail which is not present in our legislation and as such I should be very careful about importing these concepts. That should properly be the responsibility of Parliament. We should also keep in mind that "eligible financial contracts" are the exception and not the rule in the CCAA so we should be careful about too readily expanding what is within the ambit of the term[31].

3.2.2 Blue Range Resource Corp. – Court of Appeal

On appeal to the Alberta Court of Appeal, the Court held that the contracts in question were EFCs and, therefore, exempt from the stay of proceedings against Blue Range. The Court of Appeal looked at the derivatives market and examined how parties in the marketplace use these tools. Many of the trades involved buying and selling the right to take delivery of a commodity at a future date. However, this does not mean that the party actually contemplates taking delivery. Rather, due to the liquidity of the natural gas

[31] *Ibid* at paras. 51-53.

market, a party can enter into an offsetting arrangement by entering into an agreement to deliver the same quantity of gas that it has an obligation to take delivery of under its contract[32]. The Court received evidence that, "like other financial markets, the volume of gas traded on a daily basis far exceeds the amount of natural gas that actually flows through the system"[33].

The Court examined the stay provisions of the CCAA and explained that absent the exception for EFCs, the stay provisions create disparities. It went on to observe that:

> [w]hile the non-defaulting party is subject to the stay order and may not terminate its contracts, the debtor company suffers from no similar disability. Subject to the court's supervision it may terminate and breach contracts with impunity, forcing the non-defaulting party to claim damages as an unsecured creditor in the CCAA proceedings. The ability to selectively repudiate contracts is disdainfully known as "cherry picking". The debtor company could, for example, retain "out of the money" transactions speculating that they might improve in value, but knowing full well that it would not be able to pay if the market moved in the other direction. At the same time it might terminate "in the money" transactions, triggering a cash payment by the non-defaulting party[34].

The disparity created between the parties is that the insolvent party would be in complete control (were the stay of proceedings to apply to these contracts) and the non-defaulting party could not rely on performance, could not re-hedge its risk by entering into other

[32] *Blue Range – C.A.*, *supra* note 15 at para. 25.
[33] *Ibid* at para 26.
[34] *Ibid* at para 28.

offsetting agreements, and, finally, would be "exposed to excessive and unmanageable risk"[35].

The Court of Appeal recognized that some of the specifically enumerated contracts in section 11.1(1) of the CCAA are physically settled and stated that these physically settled contracts are important to the derivatives market as a whole, both in their own right and as combinations with other instruments. Therefore, the Court concluded that Parliament could not have intended to exclude physically settled instruments from its definition of EFCs, particularly since some of the enumerated contracts (i.e. spot contracts, spot foreign exchange contracts and repurchase or reverse repurchase agreements) can only be settled by physical delivery[36].

Once the term "forward commodity contract" is interpreted to include physically settled contracts, there is a risk that it could include any future contract. As a result, the Court of Appeal determined that "commodity" was the relevant word and that it must be defined narrowly to avoid defeating the purpose of the CCAA[37]. After a review of whether Parliament intended to include within the scope of forward commodity contract both those contracts that are physically and those that are financially settled, the following definition was outlined by the Alberta Court of Appeal:

> [f]orward commodity contracts are financial hedges and risk management tools … [C]ommodities must be interchangeable, and

[35] *Ibid* at para. 29.
[36] *Ibid* at para. 36.
[37] The purpose of the CCAA has been stated as: "preserving the insolvent company as a viable operation while reorganizing its affairs to benefit both the company and its creditors" (Meridian Developments Inc. v. Toronto Dominion Bank (1984), 32 Alta. L.R. (2d) 150 at 155, Quintette Coal Ltd. v. Nippon Steel Corp. (1990), 2 C.B.R. (3d) 303 (B.C.C.A.) at 309.

> readily identifiable as fungible commodities capable of being traded on a future exchange or as the underlying asset of an over-the-counter derivative transaction. Commodities must trade in a volatile market, with a sufficient trading volume to ensure a competitive trading price, in order that forward commodity contracts may be "marked to market" and their value determined[38].

The result is that manufactured goods and commercial merchandise cannot be interpreted to be included in this definition as they do not trade on a volatile market and are not completely interchangeable.

The Court of Appeal accepted evidence of a specialist in energy risk assessment to determine that the key elements of a forward commodity contract with respect to natural gas include:

- a buyer and a seller of natural gas;
- a defined contract term longer than one day for a defined volume of gas;
- a defined delivery and receipt point (including any transportation requirements, as applicable); and
- a defined price or pricing mechanism.

As a final measure, the Court of Appeal looked to the fairness of result in determining that these agreements were EFCs and, therefore, could be terminated by the counterparties. Justice Fruman remarked that Blue Range could easily sell its gas in the spot market or negotiate new long-term gas supply contracts unlike a manufacturer of consumer goods who may encounter serious financial difficulty if customers were permitted to terminate contracts for the purchase of goods. Additionally, the

[38] *Blue Range – C.A., supra* note 15 at para. 45.

counterparties, who appealed the lower court's decision, would be treated fairly in that they could crystallize their losses and limit exposure through further hedges.

In its final analysis, the Court of Appeal determined that the contracts in issue were EFCs and, as such, exempt from the CCAA stay of proceedings by virtue of section 11.1 of the CCAA. The Court concluded that both physically and financially settled transactions are included within the definition of EFC and that to restrict forward commodity contracts in paragraph 11.1(1)(h) to "cash-settled contracts is contrary to the plain meaning of the section and inconsistent with Parliament's objective of protecting the risk management structure within the derivatives market"[39].

This decision left players in the derivatives market with more comfort than the decision from the Court of Queen's Bench. Following, the Court of Appeal decision, the over-the-counter derivatives market in Canada and internationally continued to grow. The Bank for International Settlements posted an increase in daily turnover of 74% from 2001 to 2004 with $2.4 trillion being traded daily as at April 2004[40]. As a result of their reliance on the Alberta Court of Appeal decision, and also likely due to the increased activity in these instruments, parties involved in the derivatives market became concerned when the Ontario Superior Court of Justice adopted the reasoning of Justice LoVecchio of the Alberta Court of Queen's Bench in *Re Androscoggin Energy LLC*[41].

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[39] *Ibid* at para. 54.
[40] Bank for International Settlements, *Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2004*, 17 March 2005. Available at www.bis.org.
[41] (2005), 75 O.R. (3d) 552 (Ont. S.C.J.) at 554.

3.2.3 Androscoggin Energy – Ontario S.C.J.

In this decision, Androscoggin had filed for protection in the United States and sought a recognition order under s. 18.6 of the CCAA. Following this order and the stay of proceedings that was granted, various parties appeared before Justice Farley to make submissions that the gas supply contracts they had entered into with Androscoggin were EFCs under the CCAA and, therefore, not caught by the stay of proceedings and could be terminated. Justice Farley found that the "essential relationship" of the parties with Androscoggin over the term of the agreements was for the actual physical delivery of gas and, as a result, the contracts in issue were not EFCs.

In coming to his decision on this motion, Justice Farley reviewed the two Alberta decisions in the *Blue Range* case and determined that the reasoning of Justice LoVecchio at the Court of Queen's Bench was more appropriate. He found the reasoning of the Court of Appeal difficult with respect to the importance to be given to the fact that the counterparties in that case were involved in providing "risk management services" and with respect to the definition given to the term "commodity" by that Court. He stated that the restriction with respect to what contracts will be considered forward commodity contracts, "would appear to be in the main a rationalization so as to avoid virtually every commodity contract from being an EFC"[42]. Justice Farley went on to note that even if the contracts were EFCs, there was no right by the counterparties to terminate the contracts as a result of Androscoggin's insolvency. The contracts could only be terminated if Androscoggin failed to arrange for payment, which had not occurred.

[42] *Ibid* at para. 9.

In this first Ontario case dealing with the EFC provisions in the CCAA, Justice Farley struggled with the provisions in the statute and noted that both the Court of Queen's Bench and the Court of Appeal in Alberta had difficulty concluding what is an EFC for the purposes of the CCAA. He was of the opinion that this was due to the wording and approach of s.11.1 as taken from the lobbying by the Canadian Bankers' Association. Justice Farley found it unfortunate that "the same approach as was taken in the U.S. was not adopted in Canada [as this] would have quite conceivably made the job of providing similar competitive provisions much simpler"[43]. He suggested in passing that it may be of assistance for Parliament to refine the definition of EFCs as part of its review of insolvency legislation that was ongoing at the time.

The review of insolvency legislation by Parliament culminated in Bill C-55, *An Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts*, which received Royal Assent as S.C. 2005, c. 47 ("Chapter 47") on November 25, 2005. However, the Bill received Royal Assent with an agreement by the Minister of Industry that it would not be proclaimed until June 30, 2006 at the earliest in order to give the Standing Senate Committee on Banking, Trade and Commerce sufficient time to review and report on the Bill. Chapter 47 does not contain any reference to EFCs and in the unanimous observations attached to its Seventeenth Report, reporting Bill C-55 without amendment, the Senate Committee expressed its concern that:

[43] *Ibid* at para. 5.

> … further study is needed in a number of areas to ensure the effectiveness of Canada's insolvency legislation, including:
>
> - the protection, during insolvency and corporate restructuring, of eligible financial contracts in derivatives and other structured transactions … [44]

As of the date of this writing, Chapter 47 has not been proclaimed, nor has the Senate Committee received its Order of Reference to study this legislation. It is unclear at this point whether the review of Canada's insolvency legislation, which was due to be completed in 2002, will address this concern or whether participants in the derivatives market will have to wait for the next review of this legislation that will likely take place five years after the date of the relevant sunset provisions in Chapter 47 coming into force (i.e. 2011 or later). The provisions of Chapter 47 that may impact the treatment of EFCs will be discussed in section 3.3.

3.2.4 Androscoggin Energy – Ontario C.A.

The Ontario Court of Appeal, in this instance, agreed with Justice Farley that the contracts were not EFCs (although for different reasons) and also agreed that even if they were, the counterparties appealing were not entitled to terminate them. While s.11.1(2) of the CCAA provides that "no order may be made … staying or restraining the exercise of any right to terminate, amend or claim any accelerated payment" under the contract, it does not automatically allow the counterparty to terminate the contract and avoid the stay

[44] Seventeenth Report of the Standing Senate Committee on Banking, Trade and Commerce dated November 24, 2005, Jerahmiel S. Grafstein, Chair.

of proceedings. Rights of termination will only arise if they are provided for in the contract itself.

The Court of Appeal took issue with Justice Farley's conclusion that the contracts were not EFCs by virtue of the fact that they were physical in nature;

> [i]f all physically settled instruments are not EFCs, an important part of the derivatives market would be vulnerable to insolvency, weakening the Canadian risk management structure[45].

Following the reasoning of the Alberta Court of Appeal in its decision in the *Blue Range* case, the Ontario Court of Appeal concluded that the contracts at issue were not EFCs.

The hallmarks of an EFC were outlined by Fruman J.A. of the Alberta Court of Appeal and described by the Ontario Court of Appeal as contracts that:

> … enabled the parties to manage the risk of a commodity that fluctuated in price by allowing the counterparty to terminate the agreement in the event of an assignment in bankruptcy or a CCAA proceeding, to offset or net its obligations under the contracts to determine the value of the amount of the commodity yet to be delivered in the future, and to re-hedge its position[46].

The Court of Appeal further noted that although these hallmarks were not present in the contracts before it, mere insertion of these terms and conditions would not in and of itself give rise to the characterization of a contract as an EFC.

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[45] *Re Androscoggin Energy LLC* (2005), 75 O.R. (3d) 552 at 559 (C.A.) at para.12.
[46] *Ibid* at para. 15.

3.2.5 Calpine Canada Energy Ltd.

The newest case in the saga of EFCs in Canada is another case out of the Alberta Court of Queen's Bench[47]. In this case, Calpine Canada Energy Ltd. and many affiliated companies ("Calpine") sought protection from creditors under the CCAA and were granted an initial order restraining parties from terminating or suspending their obligations under agreements with Calpine, so long as Calpine continued to make payments when due at the normal prices. Immediately following the granting of the CCAA initial order, Pengrowth Corporation, the counterparty to a Call on Production Agreement[48], gave notice that it was suspending delivery under the agreement on the basis that the filing for protection under CCAA was a triggering event under the agreement and that the agreement was an EFC. After reviewing both the Alberta and Ontario Court of Appeal decisions referred to above, Justice Romaine concluded that the agreement was not an EFC.

Justice Romaine found that the agreement did not contain any of the hallmarks of an EFC as set out in the preceding case law. It did not contain a fixed price, but rather one "able to be determined", in that it relied on market pricing less toll charges. It was held that this did not constitute a price that could be prudently hedged by an off-setting contract (nor was any evidence presented to contradict this finding). Neither the term of the contract nor the volume of gas to be produced was defined and, in fact, the agreement did not oblige Pengrowth to produce at any specific rate or at all. The agreement could not be "marked to market" and therefore have a "calculable cash equivalent" as was

[47] *Re Calpine Canada Energy Ltd.*, [2006] A.J. No. 412 (Q.B.) (QL) ("*Calpine*").
[48] The agreement in this case provided for a reoccurring right of first refusal to purchase any portion of the gas or oil produced on the specified lands and to remain in force for as long as gas or oil are produced from the lands, unless terminated by the parties.

determined in the *Blue Range* Court of Appeal decision and did not contain any offsetting or netting provisions.

With respect to this final point, Justice Romaine was careful to note that although these types of provisions were referred to extensively in the *Blue Range* and *Androscoggin* cases and the importance of these provisions to the determination of whether a contract is or is not an EFC, that the mere fact of their inclusion or exclusion does not necessarily bring any contract within or outside the definition of an EFC. In essence, the contract at issue was nothing more than a standard gas utility contract[49].

In the course of her reasons, Justice Romaine made some interesting observations about the current state of Canadian legislation regarding these types of agreements. Firstly:

> … given the ingenuity and innovation of those who deal in the derivatives market, there can be no “bright-line” definition that will determine whether a contract falls within the exception set out in the CCAA. While some contracts clearly will fall within the exception, either by their nature or by reason of existing case law, there are others that do not fit so clearly and that may necessitate a more searching analysis by CCAA parties and the court[50].

And later:

> [t]here may well be criticism of a broad spectrum approach to the determination of whether a contract that is otherwise on a strict interpretation of section 11.1(1) an eligible financial contract is in reality such a contract in character and in the context of the CCAA itself. Such an approach may lead to uncertainty and a greater risk of litigation, at least until a body of case law is established. With respect to such

[49] *Calpine, supra* note 47 at paras. 18-20 and 22.
[50] *Ibid* at para. 24.

> concerns, a simple test that allows the purpose of the CCAA to be undermined with respect to certain types of commodity producers and those who deal with them is not the answer. In the absence of a more refined definition of eligible financial contract, the courts and CCAA parties will have to continue to deal with the difficult nature of the issue[51].

In her analysis of the fairness of result test, as first set out by Justice Fruman at the Alberta Court of Appeal in the *Blue Range* decision, Justice Romaine held that the respondents would be no worse off if the contract was allowed to continue than any other supplier of the debtor company. Calpine, on the other hand, would lose a valuable asset without any compensation. Additionally, as the contract came about as part of a sale of the land from which the gas is produced, it would be losing the ongoing benefit of the sale of lands[52]. Justice Romaine made the fairness of result analysis central to her decision and, in so doing, may have added greater uncertainty to this already complex area of insolvency law.

In short, the provisions with respect to EFCs have only been before the courts in three instances in the past nine years. Each time, the paragraph regarding forward commodity contracts has been at issue. In each instance, the courts involved had some difficulty interpreting the legislation. Although the decisions have not resulted in conflicting law across provinces, it appears that there is no greater certainty as to what will be considered to be an EFC without application to the courts in future instances. It is of particular note the comments made by Justice Romaine regarding the uncertainty that is left by the broad

[51] *Ibid* at para. 27.
[52] *Ibid* at paras. 28-29.

definition of EFCs contained in the CCAA without any further direction by Parliament as to its intended interpretation and application. In this writer's opinion, this is a clear indication that there is a need to review and amend the current legislation.

3.3 Possible Impact of Chapter 47

As discussed previously in section 3.2.3, *An Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts*, received Royal Assent on November 25, 2005 as S.C. 2005, c. 47. Chapter 47 does not, at present, contain any revisions to the EFC provisions in the BIA or CCAA. As such, it does not bring any further certainty to this area of law. It does, however, contain provisions that have the potential to impact EFCs and that may, in fact, bring greater uncertainty to this field. It is these provisions that will be examined below.

3.3.1 Disclaimer of Contracts

The U.S. Code contains a detailed procedure with respect to executory contracts. Executory contracts are those contracts under which there are obligations remaining to be performed by one or both parties. In bankruptcy law, this has been given a narrower meaning. The most widely accepted definition for the purposes of the U.S. Code is:

> … a contract under which both the obligations of the bankrupt ["A"] under the contract and the other party to the contract ["B"] are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other[53].

[53] Countryman, *Executory Contracts in Bankruptcy* (1974), 57 Minnesota Law Review 439 (Part 1), at 460.

Some examples of executory contracts under this definition would be:

> 1) an uncompleted construction contract under which the customer agrees to pay the builder as the work progresses;
> 2) a distribution agreement or other contract for the supply of goods or services from time to time for which the supplier periodically bills the customer;
> 3) a real estate lease or a lease of personal property under which the lessee pays periodic rentals;
> 4) a technology licensing agreement under which the licensor agrees to provide maintenance and updating facilities and the licensee pays royalties from time to time;
> 5) an employment contract.[54]

What is labelled an EFC in Canada or a forward, swap or commodity contract in the United States is a type of executory contract. Section 365 of the U.S. Code contains the primary rules with respect to treatment of executory contracts in commercial restructurings. Generally speaking, and with some exceptions and conditions, a trustee can assume or reject any executory contract or unexpired lease of the debtor[55].

Currently there is no such legislated provision in Canada, although it is generally accepted that the debtor has a right to reject most executory contracts and compromise the damages in the restructuring[56]. To remedy the perceived gap in Canadian legislation,

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[54] J.S. Ziegel, A.J. Duggan, and T.G.W. Telfer, *Canadian Bankruptcy and Insolvency Law*, (Toronto: Emond Montgomery Publications Limited, 2003) at 254.

[55] 11 U.S.C. § 365(a) (2006).

[56] See Re T. Eaton Co. (1999), 14 C.B.R. (4th) 288 (Ont. S.C.J. [Comm'l List]) paras. 6-7:

> It is clear that under CCAA proceedings debtor companies are permitted to unilaterally terminate … leases and contracts without regard to the terms of those leases and contracts including without restrictions conferred therein that might ordinarily (i.e., outside CCAA proceedings) prevent the debtor company from so repudiating the agreement. To generally restrict debtor companies would constitute an insurmountable obstacle for most debtor companies attempting to effect compromises and reorganizations under the

Chapter 47 proposes the inclusion of a section dealing specifically with disclaimer of contracts[57] in both the BIA and the CCAA. The relevant subsections in the CCAA would read as follows:

> (1) Subject to subsection (3), a debtor company may disclaim or resiliate any agreement to which it is a party on the day of the filing of the initial application in respect of the company by giving 30 days notice to the other parties to the agreement in the prescribed manner.
>
> (2) Subsection (1) does not apply in respect of
>
> (a) an eligible financial contract within the meaning of subsection 11.05(3);
>
> (b) a collective agreement;
>
> (c) a financing agreement if the debtor is the borrower; and
>
> (d) a lease of real property or an immovable if the debtor is the lessor[58].

It is clear from this language that EFCs will not be affected by this provision. The result being that Chapter 47 will not make any changes to the treatment of EFCs in this regard. This will leave Canada's treatment of EFCs in this regard the same as the U.S. treatment.

3.3.2 *Ipso Facto* Clauses

Section 365(e)(1) of the U.S. Code contains provisions with respect to what are referred to as *ipso facto* clauses. These are terms that provide for the immediate termination or modification of an executory contract that purport to come into effect as a result of:

> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;

CCAA. Such a restriction would be contrary to the purposive approach to CCAA proceedings followed by the courts to this date.

[57] Note, this is not limited to executory contracts as is the U.S. provision, but will apply to any contract not specifically exempted.

[58] Chapter 47, clause 131 (section 32 of the CCAA) (clause 44 and section 65.11 with respect to the BIA provision).

> (B) the commencement of a case under this title; or
>
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement[59].

The U.S. Code provides that these clauses are of no force and effect.

Currently, Canadian bankruptcy and insolvency legislation contains no similar provision.

Chapter 47 proposes to amend the CCAA by adding the following section:

> 34. (1) No person may terminate or amend any agreement, including a security agreement, with a debtor company, or claim an accelerated payment, or a forfeiture of the term, under any agreement, including a security agreement, with a debtor company by reason only that an order has been made under this Act in respect of the company.
>
> (2) If the agreement referred to in subsection (1) is a lease, the lessor may not terminate or amend the lease by reason only that an order has been made under this Act in respect of the company or that the company has not paid rent in respect of any period before the filing of the initial application in respect of the company.
>
> (3) No public utility may discontinue service to a debtor company by reason only that an order has been made under this Act in respect of the company or that the company has not paid for services rendered, or for goods provided, before the filing of the initial application in respect of the company.
>
> (4) Nothing in this section is to be construed as
>
>> (a) prohibiting a person from requiring payments to be made in cash for goods, services, use of leased property or other valuable consideration provided after the date of the filing of initial application in respect of the company; or
>>
>> (b) requiring the further advance of money or credit.
>
> (5) Any provision in an agreement that has the effect of providing for, or permitting, anything that, in substance, is contrary to this section is of no force or effect.
>
> (6) The court may, on application by a party to an agreement, declare that this section does not apply, or applies only to the extent declared by

[59] 11 U.S.C. §365(e)(1) (2006).

> the court, if the applicant satisfies the court that the operation of this section would likely cause the applicant significant financial hardship[60].

A similar provision is proposed to be included in the BIA, but only relating to consumer bankruptcies and consumer proposals[61]. The rationale as stated in the Industry Canada clause-by-clause analysis of the Bill is to ensure that the parties respect agreements in good standing and to ensure the debtor is not denied essential or basic services as a result of the bankruptcy alone[62].

This new provision is of interest with respect to EFCs, because it is often found that the insolvency of the party, a Credit Support Provider, or a Specified Entity is an event of default under an EFC allowing the counterparty to call for an early termination of the agreement and calculate the early termination amount[63]. Obviously, this would directly contravene the proposed section 34 of the CCAA. There is no clear exemption for EFCs in the language as drafted, but it could be argued that a counterparty to an EFC would be able to satisfy a court on an application under subsection (6) that it would suffer "significant financial hardship" if not entitled to terminate the EFC.

After lobbying to have an exemption from any stay of proceedings for EFCs, in order to allow for certainty in the volatile derivatives market, this provision will result in the Canadian market being less certain for parties to derivatives contracts. The language as drafted leaves doubt as to the treatment to be expected for EFCs and, as a result, could

[60] Chapter 47, clause 131 (section 34 of the CCAA).
[61] Chapter 47, clause 68 (section 84.2 of the BIA).
[62] As found on the Industry Canada, Corporate and Insolvency Law Policy Directorate, information page on Bill C-55 at http://strategis.ic.gc.ca/epic/internet/incilp-pdci.nsf/en/h_cl00790e.html.
[63] For example, see section 5(a)(vii) of the 2002 ISDA Master Agreement, discussed below in section 4.3.

make the Canadian derivatives market less competitive. Referring back to the Confederation Treasury decision quoted previously in section 1,

> [i]f the right to terminate contemplated in the agreement, or the selected measure of damages upon early termination, is not enforceable, the whole structure of risk management for the swaps and other transactions is weakened or may fall apart[64].

This concern is addressed in the U.S. Code. Section 556 provides:

> The contractual right of a commodity broker, financial participant, or forward contract merchant to cause the liquidation, termination, or acceleration of a commodity contract, …, or a forward contract because of a condition of the kind specified in section 365(e)(1) of this title [the provision regarding *ipso facto* clauses being inoperative], and the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forward contracts, shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by the order of a court in any proceeding under this title. As used in this section, the term "contractual right" includes a right set forth in a rule or by law … whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice[65].

Section 560 provides the same protections with respect to swap agreements.

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[64] *Confederation Treasury, supra* note 3 at para. 48, quoting from A.C. Gooch and L.G. Klein, *A Review of International and U.S. Case Law Affecting Swaps and Related Derivatives Products*, August 1, 1992 at p. 38.
[65] 11 U.S.C. §556 (2006).

4 ISDA Master Agreement

4.1 General Provisions and History

The International Swaps and Derivatives Association, Inc. ("ISDA") is a not-for-profit corporation that represents the world's major institutions and other leading participants in the privately negotiated derivatives industry. ISDA was chartered in 1985 and currently has 725 members in over 50 countries. The ISDA mandate includes the promotion of practices conducive to the efficient conduct of the business of its members in swaps and other derivatives, including the development and maintenance of standard documentation for derivatives[66]. One of ISDA's major accomplishments in the past 20 years, among others, is the development of the ISDA Master Agreement (2002 is the most current version) governing derivatives transactions.

ISDA's website outlines the two categories of derivatives as follows:

> … one consists of customized, privately negotiated derivatives, which are known generically as *over-the-counter (OTC)* derivatives or, even more generically, as *swaps*. The other category consists of standardized, exchange-traded derivatives, known generically as *futures*[67].

It is unlikely that any question would be raised in an insolvency situation that an exchange-traded derivative was not an EFC. Therefore, it is with respect to OTC derivatives that questions of applicability of the definition of EFC will arise. Many OTC derivative contracts use the form of master agreement set out by ISDA.

[66] ISDA Mission Statement – www.isda.org.
[67] ISDA website www.isda.org.

As the volume of derivatives transactions multiplied through the 1980s, the need for streamlined documentation increased. While many financial institutions and trade associations created various forms of OTC derivatives master agreements, the 1992 ISDA Master Agreement (Multicurrency – Cross Border) and related documentation is the most widely used[68]. The ISDA Master Agreement attempts to cover the breadth of OTC derivatives products rather than focussing solely on particular types of OTC derivatives products[69]. The ISDA Master Agreement is an authoritative contract that is widely used. ISDA sees this agreement and its development as a milestone because:

> … it has established international contractual standards governing privately negotiated derivatives transactions that reduce legal uncertainty and allow for reduction of credit risk through netting of contractual obligations[70].

The ISDA Master Agreement sets out the ongoing relationship between the parties and specifies the terms that the parties want included in all future transactions. It contains representations, covenants and events of default/termination events as well as provisions dealing with early termination and procedures for close-out netting on early termination. Finally, it incorporates the Schedule (where parties tailor the general provisions of the ISDA Master Agreement to their specific needs) and the Confirmations of individual transactions. Parties can use the Schedule to specify whether certain provisions will apply to each counterparty, "set applicable threshold amounts, specify additional

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[68] *Financial Derivatives, supra* note 2 at 2-2.
[69] *Ibid*.
[70] www.isda.org.

termination events, name agents to carry out various functions"[71] and define any other provisions that are relevant as between the parties to the given transaction. The Confirmations contain the economic terms of the specific transaction and any necessary modifications to the ISDA Master Agreement that would otherwise apply to the transaction[72].

A standardized ISDA Master Agreement allows for increased efficiency in the derivatives market. The standardization allows for a perceived increase in the level of judicial certainty as any decision relating to a ISDA Master Agreement can be relied on to determine the rights and obligations of the parties under any other ISDA Master Agreement. As the parties enter into specific transactions, the only documentation necessary is a Confirmation. This is generally a one to two page document that serves to specify the economic terms of the transaction (i.e. rate or price, maturity, currencies) and includes any transaction specific modifications to the ISDA Master Agreement.

There are two fundamental characteristics of all master agreements:

> [f]irst, these agreements generally state that the parties have entered into and/or anticipate entering into one or more transactions that are or will be governed by the master agreement and will from time to time execute and exchange confirming evidence (a "confirmation") setting forth the economic terms of a particular transaction governed by the general terms of the master agreement. Secondly, these agreements generally state that all transactions are entered into in reliance on the fact that the master agreement and all confirmations form a single agreement between the

[71] J. Collins and P. Sackmann, *Assessing the Legal and Regulatory Environment for Derivatives*, (prepared for *Derivatives in a Changing and Challenging Market*, June 2004) at 5.
[72] *Financial Derivatives*, *supra* note 2 at 2-4.

> parties and that the parties would not otherwise enter into any transactions[73].

The characterization of the various transactions as one agreement is of particular importance in the insolvency sphere, as it estopps an insolvent or a trustee from “cherry picking”, i.e. from retaining the transactions that are beneficial to the estate and terminating those that are not.

Additionally, market participants operating with counterparties in Canada will often include in the Schedule a representation to be read as included in section 3 of the ISDA Master Agreement similar to the following:

> [t]his Agreement constitutes an “eligible financial contract” as such term is defined in the *Bankruptcy and Insolvency Act* (Canada), the *Companies’ Creditors Arrangement Act* (Canada) and the *Winding-Up and Restructuring Act* (Canada)[74].

The 2002 ISDA Master Agreement contains provisions regarding the netting of obligations under the agreement. These are intended to be operative throughout the course of transactions between the parties to mitigate “daylight credit exposure” and are not related to the calculation and payment of termination amounts (close-out netting, discussed in section 4.4, mitigates overall credit exposures). Similar language has been contained in earlier ISDA Master Agreements. The language in the 2002 version is as follows:

> If on any date amounts would otherwise be payable:
> (i) in the same currency; and

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[73] *Ibid* at 2-3.
[74] *Ibid* at 2-22.

> (ii) in respect of the same Transaction,
> by each party to the other, then, on such date, each party's obligation to make payment of any such amount will be automatically satisfied and discharged and, if the aggregate amount that would otherwise have been payable by one party exceeds the aggregate amount that would otherwise have been payable by the other party, replaced by an obligation upon the party by which the larger aggregate amount would have been payable to pay to the other party the excess of the larger aggregate amount over the smaller aggregate amount[75].

The section goes on to indicate that the parties may elect to calculate a net amount owing in respect of amounts payable under two of more transactions on a common date and in a common currency regardless of whether the amounts are payable in respect of the same transaction. This specification is to be done in the Schedule to the ISDA Master Agreement. Generally, where parties anticipate entering into two or more transactions under the ISDA Master Agreement, this election will be made in the Schedule in order to offset various transactions.

4.2 Choice of Law/Forum in the ISDA Master Agreement

Section 13 of the 2002 ISDA Master Agreement contains the provisions dealing with choice of law and choice of forum. The standard language is drafted as follows:

> (a) Governing Law. This agreement will be governed by and construed in accordance with the law specified in the Schedule.
> (b) Jurisdiction. With respect to any suit, action or proceedings relating to any dispute arising out of or in connection with this Agreement ("Proceedings"), each party irrevocably:
> (i) submits: –

[75] 2002 ISDA Master Agreement, paragraph 2(c).

(1) if this Agreement is expressed to be governed by English law, to (A) the non-exclusive jurisdiction of the English courts if the Proceedings do not involve a Convention Court and (B) the exclusive jurisdiction of the English courts if the Proceedings do involve a Convention Court; or

(2) if this Agreement is expressed to be governed by the laws of the State of New York, to the non-exclusive jurisdiction of the courts of the State of New York and the United States District Court located in the Borough of Manhattan in New York City:

(ii) waives any objection which it may have at any time to the laying of venue of any Proceedings brought in any such court, waives any claim that such Proceedings have been brought in an inconvenient forum and further waives the right to object, with respect to the Proceedings, that such court does not have jurisdiction over such party; and

(iii) agrees, to the extent permitted by applicable law, that the bringing of the Proceedings in any one or more jurisdictions will not preclude the bringing of Proceedings in any other jurisdiction.

Canadian counterparties typically set out the Governing Law clause in the Schedule as being the laws of the particular province in which the counterparty does business and the federal laws of Canada applicable therein[76]. However, note that the User's Guide to the ISDA 2002 Master Agreement warns "[p]arties that wish to elect a governing law for the 2002 Agreement other than English law or the laws of the State of New York should carefully consider such an election with their legal advisors"[77]. It would appear that this is out of an abundance of caution and recognizing the vast number of different legal systems in which these agreements may be used.

[76] *Financial Derivatives*, *supra* note 2 at 2-12.
[77] *User's Guide to the ISDA 2002 Master Agreement, 2003 Edition*, published by the International Swaps and Derivatives Association, Inc. © 2003 ("*User's Guide*").

There is no specific case law in Canada that has developed with respect to ISDA agreements in this regard. As a result, the general laws with respect to contractual choice of law and choice of forum will prevail. Where the parties to the agreement and the subject matter of the agreement are all present in one jurisdiction and that jurisdiction is chosen in the governing law clause, there is no issue. However, once there is a "foreign element" (i.e. one or more parties, or one or more elements of the transaction that are present or take place in another jurisdiction) conflict of laws may be in issue.

Generally speaking, conflict of laws looks first to whether the court before which the dispute is brought has jurisdiction and then, if so, what law (either domestic or foreign) should the court apply to resolve the dispute[78]. With respect to contracts, the trend is to determine applicable law in such a way as to promote the reasonable expectations of the parties to the contract, subject to any need to protect weaker parties[79]. As a result of this approach, contracting parties have greater certainty on entering into a contract as to the way in which disputes thereunder will be resolved. Where there is an express choice of law, as in the ISDA Master Agreements, "…provided the intention expressed is *bona fide* and legal, and provided there is no reason for avoiding the choice on the ground of public policy …"[80] the express intention of the parties will be upheld. Legality will be determined by looking to the law of the place of contracting, the place of performance and public policy.

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[78] J-G Castel, and Janet Walker, *Canadian Conflict of Laws*, 5th Edition, (Markham: Butterworths, 2004) ("*Conflict of Laws*") at 1-4.
[79] *Ibid* at 31-1.
[80] *Vita Food Products Inc.* v. *Unus Shipping Co.*, [1938] 2 D.L.R. 372 (NS S.C.), aff'd [1939] 2 D.L.R. 1 (P.C.), [1939] A.C. 277 ("*Vita Food Products*") at 290.

Additionally, there is no requirement that the place selected have any connection with the contract or the contracting parties, so long as the parties are not seeking to avoid the mandatory laws applicable to the transaction[81], though the *bona fides* of the parties may come into question[82]. In the *Vita Food Products* case, Lord Wright reasonably stated in this regard that parties may desire the "familiar principles of English commercial law"[83] to apply. In another leading case, Justice Medhurst cites Dicey and Morris on the Conflict of Laws as follows:

> [t]he significance of the problem derives from a dilemma between the need for preventing the parties from evading the mandatory provisions of the law with which the contract is objectively most closely connected, and the need for enabling them to submit their contract to a law connected with it through financial, commercial or other links not relevant to the decision of the court and hence not disclosed to it[84].

In this way, the parties bring certainty to their contractual relations in the same way that parties to the ISDA Master Agreement may desire English or New York law to apply as these courts have expertise or are perceived as having expertise in determining issues relating to these agreements.

Courts will refuse to apply an express choice of law where public policy dictates. Matters contrary to public policy have been defined as matters of "'essential public or moral interest', … contracts 'founded in moral turpitude', and 'inconsistent with the good

[81] For example, the *Bills of Exchange Act* provides choice of law rules applicable to negotiable instruments that must be applied when determining the proper law.
[82] *Conflict of Laws, supra* note 78 at 31-3.
[83] *Vita Food Products*, *supra* note 80.
[84] *Greenshields Inc.* v. *Johnston et al.*, [1981] A.J. No. 946, 28 A.R. 1, 119 D.L.R. (3d) 714 (AB Q.B.), aff'd 131 D.L.R. (3d) 234 (C.A.) (QL) at para. 28.

order and solid interests of society'"[85]. In one case, a British Columbia court applied the Washington law that permitted indemnification for bail bonds despite the fact that such a contract was prohibited in British Columbia. The Court noted that the Washington law did not "violate an 'essential principle of justice' in British Columbia and was not 'inherently repugnant to the moral and public interests' of the Province"[86]. Further, the Saskatchewan Court followed Manitoba law even though that law offended the Saskatchewan Limitation of Civil Rights Act and observed that in order to come within the public policy exception the contract must deal with matters:

> … such as restraint of trade, champerty, interference with criminal prosecution and collusion for the purpose of obtaining a divorce. … [and] the foreign law offends a principle of morality or justice which commands almost universal recognition[87].

Based on this review, it is difficult to imagine a situation where the choice of law and choice of forum provisions in the ISDA Master Agreement might be determined to be inapplicable by an Ontario court should English law or that of the State of New York be chosen rather than the law of Ontario.

4.3 Default Clauses under the ISDA Master

Section 5 of the 2002 ISDA Master Agreement contains provisions dealing with Events of Default and Termination Events. The purpose of the default provisions is to terminate all outstanding transactions and to accelerate payment. The provisions regarding Early Termination Amount, Close-Out Netting and their calculation will be discussed below in

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[85] *Ibid* at para. 29.
[86] *Ibid* at para. 31, quoting *National Surety Co.* v. *Larsen*, [1929] 4 D.L.R. 918, [1929] 3 W.W.R. 299, 42 B.C.R. 1 (C.A.).
[87] *Ibid* at para. 32, quoting from *Canadian Acceptance Corp. Ltd.* v. *Matte et al.* (1957), 9 D.L.R. (2d) 304, 22 W.W.R. 97, [1956-1960] I.L.R. 1023n (SK C.A.).

section 4.4. These events are reciprocal and have the potential to be triggered by either party. They can also be triggered by an event affecting a third party (i.e. a Credit Support Provider). Section 5(a)(vii) is the section of the 2002 ISDA Master Agreement dealing with bankruptcy as an Event of Default. This is the only Event of Default specified under the ISDA Master Agreement that will be discussed in this paper. Actions or events in relation to a party to the ISDA Master Agreement, a Credit Support Provider or a Specified Entity[88] of the party can trigger an Event of Default under this provision. This paragraph in the 2002 ISDA Master Agreement has been drafted so as to be triggered by various events associated with bankruptcy or insolvency proceedings under United States or English law, but has been drafted broadly enough "to be triggered by analogous proceedings or events under any bankruptcy or insolvency law pertaining to a particular party"[89]. Due to the legal history of Canada's bankruptcy and insolvency legislation, the applicable concepts to Canadian law are included in the text as drafted.

In the 1992 version of the ISDA Master Agreement, there was a 30-day cure period where an insolvency proceeding was instituted or a petition presented by a third party. This has been amended in the 2002 ISDA Master Agreement such that where proceedings are instituted by a principal regulator or other primary insolvency official of a party (or its Credit Support Provider or Specified Entity) an Event of Default will be triggered immediately, but where they are instituted by another third party the cure period has been reduced to 15 days. The User's Guide explains that these changes reflect concern by members that a 30-day period was too long for those who would like to

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[88] Each party has the ability to set forth who will be a 'Credit Support Provider' or a 'Specified Entity' in the Schedule to the ISDA Master Agreement.
[89] *User's Guide*, *supra* note 77 at 14.

designate an Early Termination Date after the event. While the 15-day period may not be long enough for a party to have the filing or proceeding dismissed or stayed, it does provide adequate time for a party to communicate with a counterparty as to whether the filing is frivolous or not[90].

Section 5(c) of the 2002 ISDA Master Agreement provides for the "Hierarchy of Events" and has been expanded from the 1992 form of agreement. This change was included following the Russian debt default, "where it was argued that what could have been a Bankruptcy Event of Default had to be treated instead as an Illegality Termination Event"[91]. The effect of the change is that where there is an Illegality or Force Majeur Event, it will not also constitute an Event of Default to the extent that it relates to a failure to make a payment or delivery or a failure to comply with a material provision of the agreement or a Credit Support Document[92]. However, in all other events, if an event that gives rise to an Illegality or Force Majeur Event also constitutes an Event of Default or other Termination Event, it will be treated as such and not as an Illegality or Force Majeur Event.

Once an Event of Default has occurred (and is continuing), section 6(a) of the ISDA Master Agreement provides that the Non-Defaulting Party may give notice to the other party of the Event of Default and specify an Early Termination Date with respect to any outstanding transactions at that time. Once the notice specifying the Early Termination Date has been given, Early Termination will occur on that date regardless of whether the

[90] *Ibid*.
[91] *Ibid* at 20.
[92] Under sections 5(a)(i), 5(a)(ii)(1), or 5(a)(iii)(1) of the 2002 ISDA Master Agreement.

Event of Default is continuing at that time. If the action by the Defaulting Party has been specified in the Schedule as an event triggering an Automatic Early Termination (i.e. certain bankruptcy or insolvency events), then the Early Termination Date is the date immediately preceding that act. No notice is required where Automatic Early Termination has been selected and certain insolvency events described in section 5(a)(vii) occur[93].

The main advantage of electing to have Automatic Early Termination is that, in some jurisdictions, it may allow the Non-Defaulting party to exercise its termination rights outside the insolvency proceeding[94]. The need for this type of protection has largely been eliminated in Canada with the inclusion of EFC protections in bankruptcy and insolvency legislation. The main disadvantage of an Automatic Early Termination occurring is that the Early Termination Date may occur without the knowledge of the Non-Defaulting party. By the time the Non-Defaulting Party becomes aware of the Automatic Early Termination, the market may have moved significantly from its position on the Early Termination Date and the Non-Defaulting Party will have missed the opportunity to re-hedge or otherwise adjust its market position. As a result, most Canadian parties to the ISDA Master Agreement will elect that Automatic Early Termination does not apply[95].

[93] Specifically, 5(a)(vii)(1)(dissolution), 5(a)(vii)(3)(assignment for the benefit of creditors), 5(a)(vii)(5)(resolution passed for winding-up), 5(a)(vii)(6)(appointment of a receiver), and 5(a)(vii)(8)(any event analogous to those listed previously).
[94] *User's Guide*, *supra* note 77 at 20.
[95] *Financial Derivatives*, *supra* note 2 at 2-10.

A recent case out of the Court of Appeal for New South Wales deals specifically with the default provisions found in the 1992 ISDA Master Agreement. In *Enron Australia Pty Limited* v. *TXU Electricity Limited*[96], Enron sought to disclaim the master trading agreement, dated December 2000, between it and TXU in the form of the 1992 ISDA Master Agreement for Multicurrency – Cross Border transactions. The Court of Appeal refused the liquidator's application to disclaim the agreement and upheld the default clause under the ISDA Master Agreement.

Under the ISDA Master Agreement, Enron and TXU had entered into various swap agreements with the last open swap contract extending out to December 31, 2005. As at the end of February 2003, Enron contended that the contract had a value to it of approximately $3.3 million calculated by netting amounts payable by Enron to TXU from those amounts payable by TXU to Enron based on completed transactions at that time, as well as the present value of the outstanding transactions. Under the agreement, the appointment of voluntary administrators and later of liquidators was an Event of Default. According to the Court of Appeal:

> TXU had no obligation to make the payments under the open trades. TXU acquired a contractual right, but no obligation, to bring the relevant agreement to an end by designating an early termination date. … Enron had no contractual entitlement to bring the agreement to an end until the last date of performance under the open trades and then only on certain conditions[97].

The legislative scheme in this case provided as follows:

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[96] 2005 NSWCA 12, 53 A.C.S.R. 295 (QL) ("*Enron Australia*").
[97] *Ibid* at para. 9.

> 568(1) [*Property can be disclaimed*] Subject to this section, a liquidator of a company may at any time, on the company's behalf, by signed writing disclaim property of the company that consists of:
>
> (a) land burdened by onerous covenants; or
>
> (b) shares; or
>
> (c) property that is unsaleable or is not readily saleable; or
>
> (d) property that may give rise to a liability to pay money or some other onerous obligation; or
>
> (e) property where it is reasonable to expect that the costs, charges and expenses that would be incurred in realising the property would exceed the proceeds of realising the property; or
>
> (f) a contract;
>
> whether or not
>
> (g) except in the case of a contract – the liquidator has tried to sell the property, has taken possession of it or exercised an act of ownership in relation to it; or
>
> (h) in the case of a contract – the company or liquidator has tried to assign, or has exercised rights in relation to, the contract or any property to which it relates.
>
> …
>
> (1A) [Disclaiming contracts] A liquidator cannot disclaim a contract (other than an unprofitable contract or a lease of lane) except with the leave of the Court.
>
> (1B) On an application for leave under subsection (1A), the Court may:
>
> (a) grant leave subject to conditions; and
>
> (b) make such orders in connection with matters arising under, or relating to, the contract; as the Court considers just and equitable.
>
> …
>
> 568D(2) [Losses caused by disclaimer] A person aggrieved by the operation of a disclaimer is taken to be a creditor of the company to the extent of any loss suffered by the person because of the disclaimer and may prove such a loss as a debt in the winding up[98].

The Court of Appeal determined that disclaimer of the contract in issue would "deprive the defendants of their contractual rights, under contracts which expressly contemplate and deal with the consequences of liquidation, to decline to trigger early termination, and

[98] *Corporations Act 2001* (Cth), Pt 5.6 Div 7A, as cited in *Enron Australia*, *supra* note 96.

of the benefits they would derive from that course”[99]. The Court went on to state that the effect of the disclaimer provisions on third parties should be limited to what is necessary to release the debtor or its property from liability[100] and held that this was not an appropriate circumstance in which to grant leave to the liquidator to disclaim the agreement.

As a result, TXU and Enron will not “settle up” under the contract until either TXU designates an Early Termination Date or the expiry of all outstanding swap agreements under the contract. While this is a beneficial result for TXU, it means that other creditors of Enron cannot benefit from the current state of the agreement (i.e. cannot force payment by TXU of its out-of-the-money position) which is an asset of the estate that could be distributed to other creditors. In keeping with the risk-management purpose of these types of master agreements, however, the decision does give certainty to parties that the terms they have bargained for will be upheld.

4.4 Netting Obligations and Set-off under the ISDA Master Agreement

Following the designation of an Early Termination Date or the occurrence of an Automatic Early Termination as a result of an event of bankruptcy, all Transactions outstanding between the parties to an ISDA Master Agreement become Terminated Transactions. The obligations of the parties to make payments or deliveries pursuant to the Terminated Transactions are replaced by an Early Termination Amount. This is a new term in the 2002 ISDA Master Agreement and is defined in section 6(e) as any

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[99] *Enron Australia, supra* note 96 at para. 23 (quoting Justice Austin at first instance).
[100] *Ibid* at para. 26.

amount payable in respect of the Early Termination Date as calculated pursuant to that section.

In the 1992 ISDA Master Agreement there were two methods for calculating the measure of damages ("Market Quotation" or "Loss") as well as two payment options (the "First Method" and the "Second Method"). In response to member feedback, this has been changed in the 2002 form of agreement such that there is only one method of calculating damages and one option for payment. The "First Method" payment option under the 1992 agreement provided for what were referred to as "limited two-way payments" or a "walk away clause". Under this method, if a single net amount ran in favour of the Defaulting Party, the Non-Defaulting Party would not make that payment to the Defaulting Party[101]. This method has been deleted from the 2002 ISDA Master Agreement and parties must calculate a Close-Out Amount with respect to Terminated Transactions.

The Early Termination Amount under the 2002 ISDA Master Agreement consists of three components: (i) payments that were due or payable prior to the Early Termination Date; and (ii) payments that would have been payable or deliverable if not for the Early Termination Date, which together are referred to as Unpaid Amounts; and (iii) payments

[101] Note there is ongoing litigation in Alberta with respect to the enforceability of these provisions, among other matters, stemming from master agreements between various energy companies and Enron Canada Corp. that were terminated following Enron Corp.'s filing a petition under Chapter 11 of the U.S. Code in December 2001 (See: *Calpine Canada Natural Gas Partnership* v. *Enron Canada Corp.* (Action No. 0201-02256)(no action is being taken at the moment in this matter due to the CCAA filing by various Calpine entities in late 2005), *Dominion Exploration Partnership* v. *Enron Canada Corp.* (Action No. 0201-01117), and *Marathon Canada Ltd.* v. *Enron Canada Corp.* (Action No. 0201-07692)).

for the future value of the Terminated Transactions, which are determined by the calculation of a Close-Out Amount.

Section 14 of the 2002 ISDA Master Agreement provides for the method of calculating the Close-Out Amount. The Non-Defaulting party, or, in the case of a Termination Event, the Non-Affected party, (the “Determining Party”) makes a calculation of how much it would cost to replace, or provide the economic equivalent, of the material elements of the terminated transactions and any option rights the parties had with respect to the terminated transaction. The Determining Party is directed to refer to any relevant information, which may include one or more of the following: (i) quotations for replacement transactions by one or more third parties that may take into account the Determining Party’s creditworthiness and terms of relevant documentation between it and the third party; (ii) relevant market data (i.e. rates, prices, yields, yield curves, volatilities, spreads, correlations, etc) supplied by one or more third parties; or (iii) quotations or market data from internal sources in order to quantify its damages.

The third parties referred to may include dealers, end-users, information vendors, brokers, and other market sources. The Determining Party must act in good faith and use “commercially reasonable procedures” in making the calculation. It will consider quotations from the sources referred to above except where it believes in good faith that the information is not readily available or would produce a result that would not satisfy the standards set out in the definition. The Determining Party may also include in its calculation losses or costs incurred in terminating or reestablishing a hedge, so long as it is commercially reasonable to do so and these costs have not been otherwise included in the calculation. This new method of calculation is intended to provide more guidance and overcome perceived difficulties associated with the previous methods. Specifically, the final paragraph of the Close-Out Amount definition gives examples of commercially reasonable procedures including the application of:

- pricing or other valuation models to relevant market data and internal models, provided these are typically used by the Determining Party in the regular course of its business; and
- different valuation methods to individual Terminated Transactions or groups of Terminated Transactions depending on the type, complexity, size or number of Terminated Transactions.

Where an Event of Default has occurred, section 6(e) provides that the Close-Out Amount for each Terminated Transaction or group of Terminated Transactions be added together and the net amount added to the Unpaid Amounts owed to the Non-Defaulting Party. The Unpaid Amounts owed to the Defaulting Party are then subtracted from this total and, if positive, the Defaulting Party pays the net amount to the Non-Defaulting Party and, if the net amount is negative, the Non-Defaulting Party pays the absolute value (i.e. that amount as a positive sum) to the Defaulting Party.

Section 6(f), which is also new to the 2002 form of agreement, specifically deals with set-off of obligations in calculating any Early Termination Amount. In the 1992 form of agreement, no provision for set-off was included. However, the User's Guide to the 1992

ISDA Master Agreement contained proposed clauses that the parties could choose to incorporate. Some of these proposed clauses included provisions for what is referred to as affiliate set-off[102]. Affiliate set-off provides for set-off of claims arising not only between the parties to the agreement, but set off of claims to and from affiliates of the parties. This type of provision causes difficulties when the Non-Defaulting Party to an agreement purports to set-off amounts owed by an affiliate of the Defaulting Party to one of its affiliates against amounts it owes to the Defaulting Party. Typically neither of the affiliates is party to the agreement, but the set-off provision has supposedly compromised their rights. In this respect, clauses providing for affiliate set-off may not be enforceable[103].

The 2002 ISDA Master Agreement provides in section 6(f) that any Early Termination Amount payable to the payee by the payor (whichever party each may be) will, at the option of the Non-Defaulting Party, be reduced by any other amounts payable by the payee to the payor "(whether or not arising under this Agreement, matured or contingent and irrespective of the currency, place of payment or place of booking of the obligation)"[104]. In this way, the Non-Defaulting Party has the election to decrease amounts payable by it to the Defaulting Party or to elect not to set-off amounts owed to the Defaulting Party from the Early Termination Amount payable to the Non-Defaulting Party. Issues of affiliate set-off are not raised with respect to this provision.

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[102] *Financial Derivatives, supra* note 2 at 6-5.
[103] *Ibid*.
[104] 2002 ISDA Master Agreement, paragraph 6(f).

Parties to ISDA Master Agreements (and other derivatives contracts) require the certainty that these provisions will be enforceable and are not willing to accept the risk that they may not be as parties to other commercial transactions may. Two main reasons for this can be found in (a) the fact that various parties to these agreements may be subject to external regulations with respect to capital adequacy (i.e. Canadian financial institutions); and (b) the derivatives market is highly competitive and entities in jurisdictions that do not uphold these provisions may be at a severe disadvantage in entering the market.

Canada, through its legislation with respect to EFCs and its general insolvency legislation regarding the rights of set-off, for example, can be considered a “netting-friendly” jurisdiction. Parties must be clear, however, that Canadian insolvency legislation will not give them rights for which they have not otherwise bargained. This is discussed in the *Androscoggin* case, cited above. Specifically, the definition of “net termination value” contained in both the BIA and the CCAA provides that the netting and setting off of obligations must be in accordance with the provisions contained in the contract. As a result, parties would be prudent to carry out their transactions under an ISDA Master Agreement or a similar termination and netting agreement.

5 “Safe Harbors” in the United States Bankruptcy Code

This section will look generally at the “safe harbor” provisions in the U.S. Code that provide special protections for commodities and forward contracts, securities contracts, repurchase agreements and swap agreements. The protections provided to each of these types of agreement are the same. As forward contracts are effectively the same as forward commodity contracts in the Canadian legislation, the discussion will focus on these in order to draw comparisons between the two systems.

5.1 Chapter 11 of the U.S. Bankruptcy Code

Unlike the Canadian situation where bankruptcy legislation is contained in different statutes, all legislation relating to bankruptcy in the United States is found in Title 11 of the U.S. Code. In contrast to the CCAA, reorganization proceedings are highly codified, with much effort having gone into attempting to anticipate anything that could arise in a restructuring. It is from this chapter that the concept of EFCs was brought to Canada (through lobbying efforts by the Canadian Bankers' Association, referred to earlier in section 2).

Devised within the U.S. Code are provisions to protect commodities and forward contracts, securities contracts, repurchase agreements, and swap agreements, which are often referred to as "safe harbor" provisions. Firstly, they are exempted from the automatic stay of proceedings[105], secondly, counterparties may take the first-step in terminating these types of contracts rather than waiting for the trustee to make a decision as to whether to assume or reject the contract[106], and, finally, these agreements are not subject to all preference demands (i.e. regarding settlement payments) and other avoidance of pre-petition payments actions[107].

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[105] 11 U.S.C. §362(b)(6) (2006).
[106] 11 U.S.C. §555, §556, §559 and §560 (2006).
[107] 11 U.S.C. §546(e) and §548(d) (2006). Section 546(e) deals with transfers within prescribed time (Trustee may not avoid a transfer that is a margin payment or settlement payment made to a forward contract merchant unless that payment was made fraudulently). Section 548(d) deals with fraudulent

The filing of a bankruptcy petition does not operate as a stay of set-off by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, as those terms are defined in the U.S. Code, with regard to mutual debts or claims for a margin payment or settlement payment arising under a commodity contract, forward contract, or securities contract (§362(b)(6)), repurchase agreement (§362(b)(7)), or swap agreement as to cash or property held as collateral (§362(b)(17)). Without these special protections, a counterparty to one of these types of agreement would experience interference with its contractual rights. Specifically, the automatic stay would prohibit it from exercising rights of termination, liquidation and netting or closing out the contract[108]. Also, as an executory contract, it would be enforceable by the debtor, but not against it, until the contract was assumed or rejected under §365 of the U.S. Code.

If these types of transactions could be reversed, it would "undermine confidence in the system of guarantees and could lead to the 'ripple effect' of bankruptcy filings by other participants in the chain of guarantees"[109]. The purpose of the "safe harbor" provisions regarding settlement payments has been said to be "to protect the nation's financial markets from the instability caused by the reversal of settled securities transactions"[110].

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transfers (a commodity broker who receives a margin payment is considered to receive it for 'value' for the purpose of the section).

[108] 11 U.S.C. §556 (2006).

[109] *Re Enron Corp.*, 325 B.R. 671; 2005 Bankr. LEXIS 1123; 44 Bankr. Ct. Dec. 250 (U.S. Bankr. Ct. S.D.N.Y., 2005) at 684.

[110] *Kaiser Steel Corp.* v. *Charles Schwab & Co., Inc. (In re Kaiser Steel Corp.)*, 913 F.2d 846 at 848 (U.S. Ct. of Appeals, 10th Circuit, 1990).

There are strong policy considerations supporting a broad interpretation of settlement payments to protect securities market participants and to promote finality of securities transactions as:

> Congress recognized [in §546(e)] that the unwinding of settled securities transactions could create an environment hostile to capital formation, engendering diminished investor confidence, as well as increased costs and volatility of transactions in capital markets[111].

This must be balanced against the overriding intent in bankruptcy legislation that creditors of equal rank will share equally in the bankrupt estate. As a result, the various Courts of Appeals have taken different positions with respect to their interpretation of the term 'settlement payments' as follows:

> … the Third, Fifth, and Tenth Circuits interpret 'settlement payments' broadly and do not require the implication of national securities markets or clearing systems, whereas the Eleventh Circuit utilizes a more restrictive definition and requires the involvement of securities markets and financial clearing systems. The Ninth Circuit interprets 'settlement payment' broadly but has not addressed the issue of whether securities markets or clearing systems are essential[112].

With regard to forward contracts, in order to obtain these "safe harbors" the counterparty must be able to show not only that the contract at issue is a forward contract, but also that the counterparty is a "forward contract merchant". This term is defined in the U.S. Code as:

> … a Federal reserve bank, or an entity in the business of which consists in whole or in part of entering into forward contracts as or with

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[111] Rhett G. Campbell, *Energy Future and Forward Contracts, Safe Harbors and the Bankruptcy Code*, 78 Am. Bank. L.J. 1 at 18.
[112] *Ibid* at 19.

> merchants in a commodity (as defined in section 761) or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade[113].

This definition was put in place in order that these provisions would be used to protect true forward contracts and not ordinary supply contracts between producers and end-users. So long as one party to the transaction is a forward contract merchant, the contract is exempted from the stay of proceedings no matter whether it was entered into with a producer, end-user or third party[114].

5.2 Recent United States Case Law

5.2.1 Olympic Natural Gas

Olympic Natural Gas was involuntarily petitioned into bankruptcy under Chapter 7 of the U.S. Code in June 1997. Prior to that date, it had been party to a Natural Gas Sales and Purchase Contract with Morgan Stanley whereby the parties would enter into a series of transactions on a monthly basis for the purchase and sale of natural gas. The contract provided for a single net payment to be made each month in settlement of the transactions that had been completed that month. Over the course of the three-months prior to Olympic being petitioned into bankruptcy, payments were made to Morgan Stanley totalling $1.8 million in settlement of these monthly transactions under the contract. Olympic's Trustee sought to avoid these payments as preferential[115] or fraudulent[116] transfers under the U.S. Code. Morgan Stanley's defence was that these were settlement

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[113] 11 U.S.C. § 101(26) (2006).
[114] Opinion of Kenneth Raisler, partner, Sullivan & Cromwell, New York as noted in *Blue Range –C.A., supra* note 15 at note 9.
[115] 11 U.S.C. §547(b) (2006).
[116] 11 U.S.C. §548 (2006).

payments made to a forward contract merchant and thereby protected by the safe harbor provisions of the U.S. Code. The Bankruptcy Court, District Court and the Court of Appeals for the Fifth Circuit all agreed and summary judgment was granted in Morgan Stanley's favour[117].

This case is interesting, because it looks at the safe harbor provisions under the U.S. Code and their operation. The provision at issue in this case was section 546(e) of the Code that provides:

> [n]otwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title [avoidance by the trustee of voidable transactions, statutory liens, preferences, and fraudulent transfers, respectively], the trustee may not avoid a transfer that is a margin payment, … or settlement payment, … made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency, that is made before the commencement of the case, except under section 548(a)(1)(A) [transaction made with the intent to hinder or defraud the bankrupt estate] of this title[118].

The Court of Appeals went through the process of determining whether or not Morgan Stanley was a forward contract merchant by first determining whether the contract at issue was a forward contract as defined by the Code. The Court determined that the contracts were forward contracts pursuant to §101(25), reproduced previously in section 3.1.

[117] *Re Olympic Natural Gas Co.*, 294 F.3d 737; 2002 U.S. App. LEXIS 12848; Bankr. L. Rep. (CCH) P78,683; 39 Bankr. Ct. Dec. 221; 159 Oil & Gas Rep. 555 (U.S. Ct. of Appeals, 5th Circuit, 2002) ("*Olympic*").

[118] 11 U.S.C. §546(e) (2004). Note, the U.S. Code has been amended to include "financial participant" as one of the excepted parties at 11 U.S.C. §546(e) (2006).

Some issue was made about the use of the words “(other than a commodity contract)” in the definition. The use of this parenthetical term has resulted in some confusion regarding the definition of forward contract. The confusion is heightened by the fact that the general definitions section of the U.S. Code (§101) does not contain a definition of a commodity contract. A definition is found in §761(4), which characterizes a commodity contract as a contract traded on a national exchange. This would exclude OTC derivatives from its reach. The Trustee contended that this reflected the intent of the drafters to divide the world of commodities into three parts: “(1) futures, or on-exchange financial instruments; (2) forwards, or off-exchange financial instruments; and (3) ordinary commodity contracts (i.e. contracts for the commercial supply of goods with a future delivery date)”[119].

The Trustee argued that the safe harbor provided by section 546(e) was only available to on-exchange transactions as its intent was to prevent disruptions in the securities markets. The Court noted that the legislative history of the provision indicated it was intended “to minimize the displacement caused in the commodities and securities markets in the event [of] a major bankruptcy affecting those industries”[120] and to prevent a so-called “ripple-effect” caused by the insolvency of one commodity firm, spreading to others and threatening the collapse of the industry.

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[119] *Olympic*, *supra* note 117 at 740.
[120] *Ibid* at note 5, quoting from House of Representatives Report No. 97-420 at 1 (1982), reprinted in 1982 U.S.C.C.A.N. 583.

The contention of Morgan Stanley, which was adopted by the Court of Appeals was that the commodities market is divided into two categories: on-exchange and off-exchange transactions. The Court agreed with Morgan Stanley's position and cited Collier on Bankruptcy:

> … the terms 'commodity contract' and 'forward contract' when taken together, seamlessly cover the entirety of transactions in the commodity and forward contract markets, whether exchange-traded, regulated, over-the-counter, or private[121].

In its final analysis, the Court clarified that the parenthetical in the statutory definition merely acts to reinforce the distinction between on- and off-exchange transactions and held that a forward contract is any contract for commodities with forward performance (at least two days after the contract date), whether financial or physical, except those traded on a national exchange[122].

This decision briefly discussed the issue of contracts with physical purposes versus those with financial purposes, as was considered by both Justice LoVecchio and Justice Farley in the Canadian cases discussed earlier. Even in the more codified sphere of the U.S. Code, there is room for confusion in the OTC derivatives market. In reference to an argument by the Trustee that the transactions contemplated physical delivery of the gas and, therefore, could not be considered true "forward contracts", the Court stated that:

> … courts in other circuits have repeatedly stated that one of the distinguishing characteristics of a forward contract is that the parties expect to make actual delivery. …

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[121] *Olympic, supra* note 117 at 741.
[122] *Ibid* at 741.

> In sum, we see no reason to adopt the interpretation the Trustee advocates, and distinguish between "financial" forward contracts , and "ordinary purchase and sale" forward contracts, when the statutory language makes no such distinction[123].

The conclusion that no distinction need be made regarding the characteristics of the contract was reached more succinctly in this decision. As the U.S. Code makes no distinction as to the nature of the contract, the drafters could not have intended a distinction. In dealing with a more codified set of laws, these conclusions are more easily reached.

As the Court concluded that the contract in issue was a forward contract and that Morgan Stanley was a forward contract merchant, the payments made in the three months prior to Olympic's involuntary petition were properly within the safe harbor provisions in section 546(e) and the Trustee could not avoid these payments.

5.2.2 Mirant Corporation

In this case, Mirant Americas Energy Marketing, L.P. ("Mirant Americas"), a subsidiary of Mirant Corporation, entered into a Gas Master Service Agreement (the "Gas Master") and a Transaction Agreement with Kern Oil & Refining Co., an independent oil refining company that produces and sells "environmentally superior" products. Kern required an assured quantity of gas at an affordable price in order to fuel the electric cogeneration facility it was constructing. The Gas Master provided that Mirant Americas would sell a set quantity of gas to Kern at a set price. Following this agreement, the two parties

[123] *Ibid* at 742.

entered into a Master Monthly Netting, Close-Out Netting and Margin Agreement (the "Netting Agreement") that purported to apply to all existing and future agreements between the parties. Mirant Americas, along with other Mirant entities, subsequently filed for protection under chapter 11 of the U.S. Code.

Recognizing that they were parties to various forward contracts that would be entitled to safe harbor protections under the U.S. Code, the Mirant entities filed a motion for the benefit of entities who were entitled to protection under sections 362(b)(6) and 556 or 560[124]. The Interim Order granted extended much further and purported to extend protection to counterparties in "master agreements, long-term confirmation agreements, netting agreements, master netting agreements … and any transaction thereunder …"[125]. The Interim Order further provided that any counterparty that continued to deal with the debtors following the order was "deemed … to have accepted the benefits and protections" of the Interim Order and to have "waived the contractual right to cause a liquidation of a … forward contract"[126]. However, this waiver was deemed to be null and void should the debtors elect to reject the underlying contract. Through motions that followed, Kern sought confirmation that it would receive the protections outlined in the Interim Order, Mirant objected that its contract with Kern was not a forward contract, and the Interim Order was clarified to apply only to forward contracts, commodity contracts, or swap agreements as defined by the U.S. Code.

[124] These sections allow parties to commodities contracts, forward contracts and swap agreements to avoid the automatic stay and enforce *ipso facto* clauses.
[125] *Re Mirant Corporation, et al.*, 310 B.R. 548; 2004 Bankr. LEXIS 655; 43 Bankr. Ct. Dec. 37 (U.S. Bankr. Ct. N.D. Tex., 2004) ("*Mirant*") at 554.
[126] *Ibid*.

Following the filing of the chapter 11 petition, Mirant Americas continued to supply gas to Kern and to bill Kern according to the terms of the agreements between the parties. Three months after the filing, Mirant Americas sought to reject the agreements with Kern. Kern's response was to notify Mirant Americas that it was liquidating the agreements pursuant to their terms. Mirant Americas claimed that Kern had violated the automatic stay through its purported liquidation of the agreements and Kern countered that the agreements were forward contracts and therefore, Kern was entitled to the benefit of the safe harbor provisions of the Code.

The Court looked at the definition of forward contract in the Code and parsed the definition as:

> A contract (other than a commodity contract) for the purchase [or] sale … or a commodity, as defined in section 761(8)[127] … or any similar good … or interest which is presently or in the future becomes the subject of dealing in the forward contract trade … with a maturity date more than two days after the date [of] the contract[128].

From this, it determined that gas is a commodity and that all other criteria were met such that the agreements were forward contracts. The test under the U.S. Code is somewhat more complicated than this, however, as the party must be acting as a "forward contract merchant" in order to seek the protections of sections 362(b)(6) and 556. This is the

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[127] Section 761(8) adopts the definition of commodity found in the Commodity Exchange Act, *7 U.S.C. §1 et seq.*. Section 1(a)(4) of the Commodity Exchange Act defines commodity as:

> wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions as provided in section 13-1 of this title, and *all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in*. [emphasis added]

[128] *Mirant, supra* note 125 at 565.

relevant test. The court found support for this view in looking to the Congressional purpose to protect forward contract merchants and to ensure that the markets in which they participate are not destabilized by any uncertainty as to the treatment of their financial instruments under the U.S. Code rather than simply to protect a certain class of transactions (i.e. forward contracts)[129].

The court determined that the definition of forward contract merchant is something more than one who enters into forward contracts and that the key portion of the definition is that it must be "a person whose *business* consists in whole or in part of entering into forward contracts as or with a *merchant* …"[130]. After determining that a merchant is "one who buys, sells, or trades in a market"[131] and a business is "something one engages in to generate a profit"[132], the court concluded that a forward contract merchant is "a person that, in order to profit, engages in the forward contract trade as a merchant or with merchants"[133]. The court determined that this narrow definition was necessary to avoid an absurd result (i.e. allowing almost any party to a contract for goods or services to avoid the automatic stay of proceedings and to enforce *ipso facto* clauses).

Using this definition, the court could not determine that Kern "entered into the Agreement as a participant seeking profit in the forward contract trade"[134] and therefore, the Court could not conclude that Kern was a forward contract merchant for the purposes

[129] *Ibid* at 567.
[130] *Ibid* (emphasis in original).
[131] *Ibid*.
[132] *Ibid* at 568.
[133] *Ibid*.
[134] *Ibid* at 570.

of the summary judgment motion and denied the motion. The court noted that Kern was the end-user of the gas supplied by Mirant Americas, but stated that this alone did not preclude it from acting as a forward contract merchant in respect of the contracts:

> [p]roducers and customers may engage in the forward contract trade and may do so (even with respect to contracts based on their own production or consumption) seeking a profit. The definition of "forward contract merchant" includes a person whose business is "in part" entering into forward contracts. Thus a person who is principally in another business but speculates in the forward contract trade is, for such purpose, a forward contract merchant[135].

It would appear that this case was settled amongst the parties as there are no further reported decisions to indicate how the matter was finally determined.

5.2.3 Enron Corp.

Prior to their liquidation, Enron Corp. and its affiliated companies ("Enron") were marketers of electricity and natural gas. They delivered energy and other physical commodities, and provided financial and risk management services. As a result of inappropriate financial manipulations and accounting practices coupled with poor trading practices and a "too big to fail attitude", in December 2001, Enron sought relief under chapter 11 of the U.S. Code. Some case law has come of this event, as Enron was involved in forward contracts with many counterparties.

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[135] *Ibid* at note 34.

In one of these cases, the law of set-off in respect of forward contracts is discussed with an interesting twist[136]. Duke Energy Trading and Marketing LLC and Duke Energy Merchants LLC ("Duke") were parties to forward contracts with various Enron entities that were party to the chapter 11 proceedings discussed above (the "Enron Entities"). Each of the master agreements in issue contained a clause allowing termination if a counterparty or Enron Corp. filed for bankruptcy. As a result, Duke was in a position to terminate its agreements with the Enron entities. With respect to some agreements, Duke was in the money and with respect to others it was out of the money.

In order to avoid making payment with respect to some agreements where Duke could only hope to obtain partial payment from the bankrupt estate with respect to monies owed to it under other agreements, Duke argued that it should be able to treat all the Enron Entities as one corporate identity in order to calculate amounts owing to and from Duke. Duke sought to effectively "pierce the corporate veil" of the Enron Entities as a result of the alleged looting and control of some of the debtor corporations by other of the debtor corporations. Duke further argued that the conduct of the Enron Entities in presenting themselves as a single enterprise, the manner in which they transacted business and the entangled inter-company affairs entitled it to treat them as one entity[137]. The result of this conduct was that Duke could not collect from the looted entities that owe it money, yet it still owed money to other debtor entities[138]. The court held that Duke did not have standing to raise an action to pierce the corporate veil of the Enron Entities and as a

[136] *Re Enron Corp., et al.*, Debtors, *Duke Energy Trading and Marketing LLC, and Duke Energy Merchants, LLC,* Plaintiffs, *v. Enron Corp. et al.,* Defendants, 2003 Bankr. LEXIS 330 (U.S. Bankr. Ct. S.D.N.Y., 2003).
[137] *Ibid* at 16.
[138] *Ibid* at 18.

result, could not maintain its claim to set-off of amounts owed to one entity with those due from another.

In another set of adversary proceedings, affirmed by the District Court, various investment banks sought the protection of the safe harbor provisions where Enron sought to avoid payments made to various investment banks in the three months prior to its filing under chapter 11[139]. At first instance, Bankruptcy Judge Gonzalez held that the payments to the investment banks could be avoided, because they were made for the purchase of Enron's own shares in contravention of Oregon State law. The court found that the act of Enron purchasing its own shares from the investment banks (which pursuant to Oregon state law amounted to illegal distributions to a shareholder of an insolvent company) was void, and a nullity. Therefore, the payment could not be said to be a "commonly used" payment in the forward contract trade or securities trade (a necessary component to fit the definition of settlement payment[140]). The court concluded that:

> Where a transaction is rendered void by state law, it is a nullity. Thus, the purpose of subsection 546(g) is not implicated. The transaction is void and there is no recognized financial instrument to protect from the "uncertainties regarding [its treatment] under the Bankruptcy Code"[141].

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[139] *Re Enron Corp., et al.*, Debtors, *Enron Corp.*, Plaintiff *v. Credit Suisse First Boston International et al.*, Defendants. *Enron Corp.*, Plaintiff *v. Bear, Stearns International, Ltd., et al.*, Defendants. *Enron Corp.*, Plaintiff *v. UBS AG and UBS Securities LLC, f/k/a/ UBS Warburg LLC (a/k/a/ UBS Warburg).*, Defendants. 2006 U.S. Dist. LEXIS 57422 (U.S. Dist. Ct. S.D.N.Y., 2006).

[140] Settlement Payment, for the purposes of the forward contract provisions, is defined at §101(51A) of the U.S. Code as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade." With respect to the securities trade, the definition is functionally the same with the final line being "any other similar payment commonly used in the securities trade".

[141] *Re Enron Corp., et al.*, Reorganized Debtors, *Enron Corp. and Enron North America Corp.*, Plaintiffs *v. Bear, Stearns International Limited and Bear, Stearns Securities Corp.*, Defendants, 323 B.R. 857; 2005 Bankr. LEXIS 701; 44 Bankr. Ct. Dec. 193 (U.S. Bankr. Ct. S.D.N.Y., 2005).

In yet another adversary proceeding, Enron sought to avoid payments made to International Finance Corp. to purchase notes offered by a Trust created as part of a transaction whereby Enron monetized a portfolio of loan facilities owned by Enron North America Corp. In this case, the court held that the payments were common in the securities trade and were saved by the safe harbor provisions[142]. Of interest, however, is the court's observation that as with the commercial paper transactions with the investment banks referred to above:

> … the transactions here are examples of Enron apparently going into the market place and overpaying for the product it purchased to, among other things, protect its credit rating. … in the instant transactions that intent was carried out within the narrow confines of the security transactions. Therefore, although Enron may be able to establish that, in many ways, the safe harbor is being used as a sword and not as a shield for marketplace stability, as intended, the parties to the instant transactions are protected because their transactions did not involve outright illegality or transparent manipulation as was present in the earlier cases which, among other things, rendered the payments not commonly used in the securities industry[143].

What these two sets of proceedings show is that even though Enron knowingly engaged in improper (or illegal) acts, the counterparty investment banks could only seek the safe harbor protections where the acts fit within the confines of securities or forward contract trade. While the actions by Enron in the Bear, Stearns et al. decisions were illegal as to render the transactions outside of the safe harbor provisions, those with International Finance, although improper, were still able to come within the definition of payments commonly used in the industry.

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[142] *Re Enron Corp., et al.,* Reorganized Debtors, *Enron Corp.,* Plaintiff *v. International Finance Corp. et al.,* Defendants, 341 B.R. 451; 2006 Bankr. LEXIS 1034 (U.S. Bankr. Ct. S.D.N.Y., 2006).
[143] *Ibid* at 23-24.

Of more interest, particularly from the point of view of legislative certainty, is the order that was granted May 30, 2002 (the "Safe Harbor Order"), establishing and authorizing procedures for settlement of terminated safe harbor agreements. As Enron was a party to many contracts, which were eligible for safe harbor treatment under the provisions discussed previously and could be terminated by the counterparty on its insolvency, a procedure was put in place to allow for the efficient settlement of any non-contested agreements. Additionally, the Safe Harbor Order sets out the procedure for valuing damages, dealing with disputes as to damage claims, and bringing settlements to the Court for approval. In a large, multi-company, insolvency and restructuring such as this one, this type of efficiency is invaluable. The certainty provided by the safe harbor provisions in the U.S. Code allows for the possibility in a highly complex restructuring to have at least some elements fast-tracked through this type of agreed procedure.

6 Discussion

6.1 Pitfalls to the Current Legislation

While one could say that the bullet has been dodged in the case law that has come out of two appeal courts in Canada regarding EFCs (specifically, forward commodity contracts)[144], a question remains as to whether this is sufficient to provide the certainty that the derivatives market requires. The Court of Appeal decision in *Blue Range* gave certainty to this area and, although followed by the Ontario Court of Appeal in the *Androscoggin* case, it has been said that Justice Weiler glossed over the Alberta Court's

[144] i.e. the cases have not resulted in conflicting appeal court decisions and, further, that the courts have to some degree provided the derivatives industry with a level of certainty as to how the EFC provisions will be interpreted by the courts.

analysis in her focus on termination and netting rights as the crucial "hallmarks" of an EFC[145]. Criticism of this conclusion has been stated as follows:

> First, any physical forward commodity contract that establishes a forward price has a financial management aspect. The purpose is to lock in both supply and price. So every forward can be said to "serve a financial purpose unrelated to the physical settlement of the contracts" by allowing a party to manage the risk of price fluctuations. In any event, given that even spot contracts are eligible financial contracts, having a financial purpose related to managing price risk should not be an important factor in determining the character of the contract. Further, among the list of eligible financial contracts are contracts to buy or sell a security. A security, at least a marketable security, is a commodity; there is no requirement with respect to securities that the parties have a financial purpose unrelated to the physical delivery of the security in order for such transactions to qualify as eligible financial contracts. The same should be true of other commodities[146].

The decision reached in the *Androscoggin* Court of Appeal decision shows parties the importance of having an ISDA Master Agreement, or another master agreement similar in form and substance, in place if they wish to have their transactions recognized as EFCs. Additionally, since discussion continues about whether purely physical transactions can be within the EFC definition of a forward commodity contract, it may be prudent to mix financial and physical contracts under one master agreement in order to support the characterization of the agreements as EFCs[147]. Whatever form of agreement the parties enter into, following the *Androscoggin* case, they should ensure the "hallmarks" discussed in that case are included in their agreements[148].

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[145] *Financial Derivatives, supra* note 2 at 5-14.
[146] *Ibid*.
[147] *Ibid*.
[148] Namely: termination on assignment into bankruptcy or commencement of CCAA proceedings, set-off or netting provisions, and the ability of the non-defaulting party to re-hedge its position.

The question has been raised, however, that despite the result of the *Androscoggin* case, which would appear to be the correct result, is *Androscoggin* correct? If it is not, this can only be blamed on legislation that has not provided sufficient guidance to the judiciary in its application. In many CCAA cases, as was the situation in *Androscoggin*, the parties have little time to prepare arguments and the court has little time to consider the evidence before rendering a decision. These factors make it even more incumbent upon Parliament to provide clear guidance.

In each of the three cases that have considered EFCs, considerable time has been spent to determine whether the relevant agreements fall within the broad definition of EFC that has been set out by Parliament. Although it is beneficial to have a broad definition which will encompass new derivative products as they are developed in the marketplace, there needs to be more direction given to the Courts (and parties to CCAA and applicable BIA proceedings) as to what will constitute an EFC in order that there is certainty in the marketplace.

The concern in the derivatives industry with respect to potential uncertainty is the "chilling effect" that this could have on the economy. This uncertainty could manifest itself in three ways, as was discussed in an article written by counsel to ISDA in the *Androscoggin* case before the Ontario Court of Appeal[149].

[149] D.W. Mann, *Eligible Financial Contracts Revisited: The Androscoggin Experience*, (2005) 21 B.F.L.R. 101 at 107.

Firstly, with respect to credit availability, credit assessment would have to be done on a gross basis, as opposed to a net basis, if certain contracts will not be considered EFCs, thereby allowing solvent counterparties to terminate and net their positions in the event that the insolvent party is granted protection from its creditors. The effect of this would be that credit exposures would be exponentially higher, hindering trading volumes or burdening parties with higher credit-support requirements.

Secondly, there would be a concern that financial institutions would be required to calculate their exposures on a gross basis, rather than a net basis, without strong legal opinions supporting the enforceability of netting provisions in these contracts. This reclassification would require financial institutions to provide additional capital in order to participate in the marketplace. The likely result would be that financial institutions would re-allocate capital to other, more lucrative, markets or pass the cost of the increased capital on to credit users.

Thirdly, Canadian counterparties in the international marketplace would be less attractive to foreign counterparties where the foreign counterparty may perceive its rights against the Canadian counterparty as unclear and potentially unenforceable. Additionally foreign financial institutions could price their derivatives products more competitively as they would not be adhering to higher capital adequacy requirements.

6.2 Comparison of U.S. and Canadian Approach

Overall, insolvency legislation is much more proscribed in the United States than that which is found within the CCAA in Canada, though is quite similar to the level of detail contained in the BIA. Unfortunately, even within the BIA, the provisions regarding treatment of EFCs in insolvency leave much room for discretion and do not provide the level of certainty that industry players may seek. One particular aspect of the U.S. legislation that could be useful in the Canadian regime is the fact that the safe harbors are limited, not only in the types of agreements protected, but the types of parties intended to be protected (i.e. a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant or securities clearing agency).

In the United States, the courts will look not only to the type of contract that is in issue, but the parties to the contract to determine whether it is one that is intended to be protected by the legislation. To include a definition requiring that one party to the EFC be in the business of entering into contracts with merchants in a commodity (as defined by Justice Fruman in the *Blue Range* Court of Appeal decision), or any similar good, article, service, right or interest which is presently or in the future becomes the subject of dealing in the EFC trade would provide greater certainty as to the types of parties and types of agreements intended to be included in the definition of EFC.

In submissions to the Ontario Court of Appeal in the *Androscoggin* case, parties suggested that this approach may lead to uncertainty because it would involve assessing a party's intention, which could change over the course of the contract[150]. Conversely, others have suggested that looking to the nature of the parties, rather than attempting to determine intent solely from the language in the contract, would be useful[151]. One could look at the actual conduct of the parties to the agreement as well as historical conduct to assist in the determination.

Although this may require an inquiry as to the intent of the parties on entering into the agreement, it would appear to provide greater clarity, particularly with respect to forward commodity contracts. Where it is unclear whether a contract is a forward commodity contract or merely a supply contract, looking to the parties to the contract and their businesses (i.e. does either party engage in the business of buying, selling or trading in the applicable market for profit) could assist the court in coming to its conclusion.

6.3 What can we learn from the U.S. experience

A defining point in the U.S. Code is that forward contracts, repurchase agreements and swap agreements are defined to include contracts that are presently or become in future the subject of dealing in this trade. This limits the broad definition to make clear that, using the forward contract definition as an example, although a contract may be a contract for the purchase and sale of a commodity, it will not be a forward contract unless it is part of the forward contract trade. Effectively, beyond looking to the type of contract, the definition looks to the purpose of the contract and how it is used. This

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[150] *Ibid* at 114.
[151] R.H. Chartrand and R.B. Schwill, *Shades of Blue: Derivatives in Re Blue Range Resource Corp.*, 16 B.F.L.R. 427 at 446.

makes clear (although Canadian jurisprudence has reached the same conclusion) that simple gas utility contracts are not subject to the exception.

The CCAA and BIA provisions regarding EFCs could be improved by including language to this effect. Following the Alberta Court of Appeal decision in the *Blue Range* case, concern was raised that the reasoning of the Court could extend to allow for the termination of a consumer contract (i.e. a long-term supply contract of natural gas to a business for its own use, which would be for a specific amount to be delivered over a specific period at a set price)[152]. By including direction in the statute that only contracts that are part of the "forward contract trade" are included in the exception, this concern could be easily addressed.

The U.S. Code has contained provisions with respect to forward contracts for longer than the Canadian legislation has included its EFC exception. Additionally, with a bigger market, more cases have been decided in the United States since these provisions came into force. It is sensible to draw on the United States experience in refining Canada's laws in this area.

On April 20, 2005, the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* was enacted. Various provisions in this Act amended or updated the U.S. Code with respect to treatment of derivatives products in insolvency. It could be said that these updates are a result of lessons learned in the United States since the original enactment of

[152] D.S. Nishimura, *The Companies' Creditors Arrangement Act and the Petroleum Industry: The Blue Range Resource Corporation Proceedings*, (2001-2002) 39 Alta. L. Rev. 35 at 59.

these provisions. Now that Canada has some case law interpreting the EFC provisions and we have seen some of the struggles resulting from the current drafting, this may be an appropriate time to refer closely to the U.S. Code and its recent amendments to consider changes to further define the Canadian legislation.

7 Conclusion

While this paper should not be taken to suggest the need for the level of proscription present in the U.S. Code within Canadian insolvency legislation, it would appear that further refinement of our present exceptions for EFCs would be instructive both to market participants and the judiciary. One of the struggles that each court dealing with EFCs has had to address is the sparse legislative history with respect to the inclusion of these exceptions in our insolvency statutes. Without more, it is difficult to decipher the legislative intent and this, along with the broad language of the present exception, has resulted in some level of uncertainty with respect to what contracts will qualify for the present exception from a stay of proceedings.

As the derivatives market is volatile and the parties involved are looking to manage risk, it is doubly important to provide them with legislative certainty as to what requirements they and their agreements must meet in order to receive protection under insolvency statutes. Some lessons could be learned from the U.S. experience and our legislation could be tweaked by Parliament to include some of the descriptive definitions that are included in the U.S. Code to provide for greater certainty to market participants of how various contracts will be treated in insolvency. By bringing more stability to this area, Canada stands to attract greater investment in the OTC derivatives market.