COMMERCIAL INSOLVENCY REPORTER

National Editor: Linc Rogers, Blake Cassels & Graydon LLP

VOLUME 26, NUMBER 6 | Cited as 26 Comm. Insol. R. | AUGUST 2014

• OSFI RELEASES FINAL LIQUIDITY ADEQUACY REQUIREMENTS GUIDELINE AND OTHER RELATED DEVELOPMENTS •

Stephanie Robinson, *Partner*, Sean Brandreth, *Associate*, and Matthew Burns, *Summer Student-at-Law*
McMillan LLP

Introduction

In November 2013, the Office of the Superintendent of Financial Institutions Canada ("OSFI") released the draft *Liquidity Adequacy Requirements Guideline* (the "LAR Guideline"). On May 30, 2014, OSFI published the finalized LAR Guideline. This article reviews the differences between the draft and the final version as well as provides OSFI's material points of clarification. It also reviews recent related developments.

The LAR Guideline deviates very little from the draft; no significant modifications to the substantive components were introduced. OSFI responded to particular comments and questions that were proposed during the comment period. The revisions primarily provide greater clarity and correct an occasional relatively minor oversight.

Overview

As was the case with the draft, a majority of the text in the finalized guideline is drawn directly from *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* ("Basel III Report"), a report prepared by the Basel Committee on Banking Supervision (the "BCBS"). The LAR Guideline includes a chapter on net cumulative cash flow, a Canada-specific metric introduced by OSFI in 2009, which is an exception to OSFI's general practice of adopting standards developed by the BCBS with little or no modification.

• In This Issue •

LexisNexis

COMMERCIAL INSOLVENCY REPORTER

The **Commercial Insolvency Reporter** is published bi-monthly by LexisNexis Canada Inc., 123 Commerce Valley Drive East, Markham, Ontario L3T 7W8

ISBN: 0-433-47336-3 **ISSN: 0832-7688**
ISBN: 0-433-47338-X (Print & PDF)
ISBN: 0-433-47337-1 (PDF)
Subscription rates: $370 per year (Print or PDF)
$490 per year (Print & PDF)

Please address all editorial inquiries to:

Boris Roginsky, Journals Editor
LexisNexis Canada Inc.
Tel. (905) 479-2665; Toll-Free Tel. 1-800-668-6481
Fax (905) 479-2826; Toll-Free Fax 1-800-461-3275
Internet e-mail: cir@lexisnexis.ca.

This article discusses recent OSFI developments that impact the administration of the LAR Guideline and, in particular, material corrections and clarifications adopted in relation to the following components of the LAR Guideline:

- Liquidity Coverage Ratio (the "LCR")
- Net Stable Funding Ratio (the "NSFR")
- Net Cumulative Cash Flow (the "NCCF")
- Additional liquidity risk monitoring tools

On July 16, 2014, OSFI issued the reporting requirements and instructions related to the LCR standard, the LCR by significant currency monitoring tool, and the NCCF monitoring tool. Beginning in January 2015, completed returns associated with these metrics are to be filed on a monthly basis by all entities to which the LAR Guideline applies. Although the BCBS is still finalizing the NSFR, this standard is expected to take effect, at least in part, by January 2018. The NCCF, with some revision, has been in effect since 2009.

Public Disclosure Requirements for Domestic Systemically Important Banks on the LCR

On July 16, 2014, OSFI also issued the final version of *Guideline D-11 – Public Disclosure Requirements for Domestic Systemically Important Banks on Liquidity Coverage Ratio* ("Guideline D-11"). Guideline D-11 sets out the public disclosure requirements for internationally active banks (*i.e.*, those institutions that have been designated as domestic systematically important banks ("D-SIBs") in Canada). To date, the D-SIB designation has been applied to Bank of Montreal, The Bank of Nova Scotia, Canadian Imperial Bank of Commerce, National Bank of Canada, Royal Bank of Canada, and The Toronto-Dominion Bank. The release of Guideline D-11 was spurred by the January 2014 publication of BCBS's *Liquidity Coverage Ratio Disclosure Standards* ("LCR-DS"), which advocates harmonization with a view to increasing the accuracy, consistency, and accessibility of LCR data. Guideline D-11 provides for the wholesale implementation of the LCR-DS, which will apply to all D-SIBs effective Q2 2015.

Liquidity Coverage Ratio

The LAR Guideline aims to ensure that an institution maintains adequate and appropriate forms of liquidity. The LCR aims to ensure that an institution maintains an adequate stock of unencumbered high-quality liquid assets (the "HQLA") that can be converted into cash at little or no loss of value in private markets to meet liquidity needs over a 30-day calendar period.

OSFI clarified that in order to include the surplus HQLA of a subsidiary in the LCR of a consolidated entity, the assets involved must be freely available in times of stress. It is, therefore, important to remain cognizant of any restrictions on repatriating assets to the parent entity. To the extent that any such restrictions exist, the affected assets cannot be included in the consolidated entity's LCR.

In the context of collateral swaps, OSFI clarified that cash outflows occur when (1) collateral borrowed is of a higher quality than the collateral lent, and (2) the swap matures within the 30-day stress horizon. In these circumstances, the cash outflow amount is the difference between the prescribed outflow and inflow rate of the collateral lent and the non-rehypothecated collateral borrowed, respectively. However, no outflow should be allocated when the collateral involved is of the same LCR type.

OSFI rejected the notion of looking through to the underlying securities in assets such as mutual funds and exchange traded funds in the calculation of the HQLA. If an individual security cannot be separately monetised, it cannot be included in the HQLA. Furthermore, OSFI refused to recognize the S&P/TSX Composite Index as the major stock index in Canada (which would mean that the HQLA could include common equity shares of issuers included in the S&P/TSX Composite Index) and instead confirmed the S&P/TSX 60 Index as the major stock index in Canada, on the basis that only the most liquid of stocks should qualify as the HQLA.

In response to concerns that smaller institutions were unduly penalized by a minimum pool size requirement of $25 million under the Bank of Canada guidelines in order to characterize *National Housing Act*[1] Mortgage-Backed Securities ("NHA MBS") and Canada Mortgage Bonds ("CMBs") as Level 1 assets, OSFI created an exception. Non-foreign, non-D-SIB institutions may include NHA MBS and CMBs with a pool size of less than $25 million as Level 1 assets.

The draft guideline required that banks subject to prudential supervision assume a 40 per cent drawdown with respect to the undrawn portion of committed credit and liquidity facilities. This was modified to apply to the broader concept of deposit-taking institutions. Absent this modification, certain institutions may have been at a disadvantage when arranging liquidity backstops.

Finally, OSFI stated that it is not contemplating an expansion of the types or categories of assets that can be included under the HQLA definition beyond what is set out in the Basel III Report.

Net Cumulative Cash Flow

The NCCF metric measures cash inflows and outflows over various time horizons in a 12- month span. As previously noted, the NCCF is a departure from the BCBS standard.

Both tools are designed to identify gaps between cash inflows and outflows; however, the NCCF incorporates a greater level of detail. As with the LCR, the final version of the LAR Guideline clarifies potential points of ambiguity and does not substantially modify the substantive rules that govern application of this metric.

Among other modifications, OSFI clarified that the NCCF threshold for small business customer deposits is $5 million on an individual account basis, not $1.5 million as defined under the LCR. In addition, OSFI reassessed the deposit run-off assumptions and adjusted certain run-offs within categories deemed to be core deposits.

Net Stable Funding Ratio

The NSFR is a BCBS standard that has not yet been finalized. However, the NSFR will require institutions to maintain a stable funding profile. Under this framework, the amount of funding required is tied directly to the institution's liquidity characteristics and off-balance-sheet exposure.

References to the NSFR in the LAR Guideline are placeholders that will be populated once the BCBS finalizes this standard. To this end, the BCBS released a draft in January 2014 and solicited feedback until April 11, 2014, when the comment period ended.

Additional Liquidity Risk Monitoring Tools

In addition to the above metrics, OSFI has a number of other liquidity monitoring tools at its disposal. These tools do not define minimum required thresholds. Instead, OSFI gathers data, using every available source, and approaches entities to discuss concerns as, and if, they arise. If OSFI determines a minimum requirement is required, its implementation will be preceded by advance notice.

Finally, OSFI stressed a preference for automatic data collection, where possible, but acknowledged that data must still be gathered manually in many instances. Where manual collection is required, OSFI indicated that its preference is that information be provided via a template that will be distributed in mid-2014.

[*Editor's note*: **Stephanie Robinson** is a Partner in McMillan's Financial Services Group. Her practice focuses on corporate finance and structured finance transactions, including domestic and cross-border commercial debt financing, syndicated lending, asset-based lending, and securitizations. Stephanie also provides regulatory advice to domestic and foreign financial institutions carrying on business in Canada, including with respect to obligations that arise under anti-money laundering legislation. She is a Certified Anti-Money Laundering Specialist.

Sean Brandreth is an Associate in McMillan's Financial Services Group. His practice includes commercial debt financing, acquisition financing, asset-based lending, project financing, secured transactions, and regulatory compliance.

Matthew Burns is a Summer Student-at-Law at McMillan.]

---

1 R.S.C. 1985, c. N-11.

• *MADOFF* BANKRUPTCY DECISION OFFERS PROTECTION FOR FOREIGN INVESTORS •

Christopher Harris, *Partner*, and Thomas Giblin, *Associate*
Latham & Watkins LLP

***In re Madoff Securities* Extends Morrison Framework to Prevent Avoidance of Purely Foreign Transfers under *SIPA* and the *Bankruptcy Code*.**

Applying the U.S. Supreme Court's landmark decision in *Morrison v. National Australian Bank Ltd.* [*Morrison*][1] to the highest profile and widest-ranging securities fraud case in decades, Judge Jed S. Rakoff of the United States District Court for the Southern District of New York ruled that the trustee administering Bernie Madoff's insolvent estate may not use the U.S. *Bankruptcy Code* to claw back "purely foreign" transactions between foreign entities.[2] By applying *Morrison* to such a visible case with a number of foreign defendants, the court recognized an important protection for foreign investors who may not have anticipated that their investments—and their returns—could otherwise be subject to clawback under U.S. law.

Background

Madoff funded his now-famous Ponzi scheme partly through the investments from so-called feeder funds—investment vehicles that pooled investments from outside investors and, in turn, invested those monies in Madoff's putative investment company, Bernard L. Madoff Investment Securities LLC (BLMIS). Many of these feeder funds were organized and operated outside the United States, and, not surprisingly, many of their investors were foreign persons or entities.

After Madoff declared his fraud in 2008, the Southern District of New York appointed Irving H. Picard as trustee of the BLMIS estate pursuant to the *Securities Investor Protection Act* [*SIPA*]. *SIPA* is a statute specifically designed to facilitate the unwinding of insolvent securities broker-dealers in such a way as to maximize the recovery for the broker-dealer's investors. The statute gives the trustee the powers to recover (or avoid) certain transfers, including those that are fraudulent or preferential, by incorporating the powers of a trustee under the *Bankruptcy Code*. Accordingly, the trustee has sought to recover so-called subsequent transfers pursuant to s. 550(a) of the *Bankruptcy Code*,[3] which allows trustees to recover avoidable transfers, even if that property has since been transferred to another person or entity.

The Court's Analysis

At issue in *In re Madoff Securities* was whether the trustee's ability to avoid subsequent transfers could be extended extraterritorially to reach transfers in foreign jurisdictions from foreign customers to other foreign persons and entities. Certain foreign defendants had asked Rakoff, U.S.D.J. to withdraw the reference to the bankruptcy court in order to consider the issue. The court granted this motion and, after briefing and argument on the issue, ruled that § 550(a) could not be applied to avoid such foreign transactions.

In *Morrison*, the Supreme Court had reaffirmed the presumption that a federal statute, absent clear Congressional intent, does not extend to extraterritorial conduct, and had set forth a two-step analysis to determine whether a statute may be applied to conduct occurring outside the United States. A court must determine whether (1) the application of the statute is truly extraterritorial and (2) Congress intended that the statute be used to reach extraterritorial conduct.

On the first question, Rakoff, U.S.D.J. reasoned that the conduct in question did not qualify as "domestic" merely because *SIPA* was intended to benefit the estate of a debtor based in the United States, such as BLMIS. Instead, the court held that "a mere connection to a U.S. debtor, be it tangential or remote, is insufficient on its own to make every application of the Bankruptcy Code domestic". Judge Rakoff reasoned that the focus of § 550(a) was not the debtor, but the subsequent transfer itself. To the extent that the transfers took place in a foreign jurisdiction, solely between two foreign entities, the transfers were "foreign transfers", and recovery thereof constituted an extraterritorial application of § 550(a).

The court then turned to the question of whether Congress intended for § 550(a) to apply to extraterritorial conduct. The court first noted that nothing in the language of § 550(a) indicated a Congressional intent to reach extraterritorial conduct. Analyzing different definitions of "property" located within the *Bankruptcy Code*, the court determined, as a matter of statutory interpretation, that Congress did not intend § 550 to reach property "wherever located and by whomever held", a formulation that, under applicable precedent, would have included foreign transactions.

Finally, the court held that neither *SIPA* itself nor policy concerns weighed in favour of rebutting the presumption against extraterritoriality. In fact, the court ruled that concerns of international comity, including the potential for conflict with foreign liquidation proceedings—such as those which many feeder funds are currently undergoing—weighed against rebutting that presumption. Respecting these foreign proceedings was especially important, the court found, because "investors in these foreign funds had no reason to expect that U.S. law would apply to their relationships with the feeder funds".

Conclusion

On the one hand, Rakoff, U.S.D.J.'s opinion in *In re Madoff Securities* constitutes a fairly straightforward and logical application of the Supreme Court's decision in *Morrison* to the Madoff trustee's attempt to use *SIPA* and the *Bankruptcy Code* to avoid purely foreign transactions. On the other hand, the court—in applying that reasoning to such a closely watched case—has visibly recognized an important protection to foreign investors who may not have anticipated that their foreign transfers could be subject to clawback under U.S. law.

[*Editor's note*: **Christopher Harris**, former Co-chair of the firm's Litigation Department in New York and the East Coast leader of the firm's insolvency litigation practice, focuses on two main practice areas: securities and other accounting-related litigation and insolvency litigation. Mr. Harris has represented most of the major banks and accounting firms in civil, regulatory, and criminal matters. He has also represented issuers in multiple-billion dollar securities litigations, securities firms and individuals in SEC investigations, and outside directors of investment banks and issuers in securities class actions and derivative actions. Mr. Harris is also a frequent speaker and writer on expert witnesses, having presented at the ABA National Conference, the American Corporate Counsel Association, and numerous other venues, and has also served as a faculty member for the Federal Judicial Center, instructing new federal bankruptcy judges about discovery issues.

Thomas Giblin is an Associate in the Litigation Department of the New York office of Latham & Watkins. His practice focuses primarily on securities litigation and white collar defence.

In addition, he is active in the firm's *pro bono* practice and currently heads the firm's Fair Housing Justice Program.]

1 130 S. Ct. 2869, 2010 U.S. LEXIS 5257.

2 *Securities Inv. Protection Corp. v. Bernard L. Madoff Investment Secs., LLC*, 12-mc-115, Dkt. No. 36, 2014 U.S. Dist. LEXIS 91508; 59 Bankr. Ct. Dec. 194 [*In re: Madoff Securities*].

3 11 U.S.C. § 550(a).

• ASSIGNING CONTRACTS IN CANADIAN INSOLVENCY PROCEEDINGS •

Adam Maerov, *Partner*, and Mitchell Allison, *Associate*
McMillan LLP

Canadian restructuring and liquidation legislation provides struggling companies and bankruptcy trustees with powerful tools to restructure their affairs and maximize value for stakeholders. For example, in the right circumstances, valuable contracts can be assigned, on notice to the counterparties, to buyers prepared to pay well for the rights conferred under the contracts. In such circumstances, the counterparty's bargained-for right to withhold its consent to an assignment can be effectively overridden by a court order. The recent decision of the Supreme Court of British Columbia in *Barafield Realty Ltd. v. Just Energy (B.C.) Limited Partnership* [*Barafield Realty*] highlights the importance of proper notice.[1]

The *Barafield Realty* Case

In *Barafield Realty*, the defendants acquired natural gas supply contracts pursuant to an asset purchase agreement entered into by the debtor in connection with its restructuring proceedings under the *Companies' Creditors Arrangement Act* [*CCAA*].[2] The contracts contained clauses that expressly prohibited assignment of the contracts without the consent of the counterparties. Other clauses permitted either party to terminate the contract upon the insolvency of the other party. The plaintiffs, who were counterparties to the contracts, were not given notice of the debtor's *CCAA* proceedings or the acquisition of the contracts by the defendants. The consent of the plaintiffs was not obtained or even sought—perhaps as a result of the significant number of customer contracts at issue.

After the plaintiffs were informed of the assignment, they initiated litigation to terminate the contracts and seek damages from the defendants. The defendants argued that the vesting order, which approved the assignment of the contracts, and the provisions of the *CCAA* eliminated the need for the defendants to obtain the plaintiffs' consent or to notify them of the proceedings.

The court rejected these arguments and held that the *CCAA*, the *Bankruptcy and Insolvency Act* [*BIA*],[3] and the wording of the vesting order did not alter the contractual rights of the plaintiffs. Among other things, the court held that *CCAA* proceedings generally cannot alter, without notice, the contractual rights of third parties.

Statutory Guidance

The *Barafield Realty CCAA* proceedings were commended in 2008. In 2009, the *CCAA* and the *BIA* were amended to provide that a court may make an order assigning an agreement upon notice to each party to that agreement to any person who is specified by the court and agrees to the assignment.[4] As such, it is now clear that courts have the jurisdiction to make an order assigning certain pre-filing contracts, provided the counterparties are given adequate notice. These provisions do not apply to post-bankruptcy or *CCAA* filing agreements, collective bargaining agreements, eligible financial contracts (*i.e.*, derivatives and certain other financial agreements), or to rights and obligations that are not assignable by reason of their nature.

In deciding whether or not to exercise its discretion to approve a proposed assignment, the court is to consider, among other things, whether (1) in a *CCAA* proceeding, the *CCAA* monitor approved the assignment, (2) the person to whom the rights and obligations are to be assigned would be able to perform the obligations, and (3) it would be appropriate to assign the rights and obligations to that person. A court may not make an order approving the assignment unless it is satisfied that all monetary defaults in relation to those agreements will be remedied on or before a date fixed by the court.

In Practice

When obtaining a vesting order, it may be possible to obtain court-ordered protections relating to the assignment (*e.g.*, clarification that contract provisions purporting to entitle the solvent counterparty to terminate the contract or imposing onerous terms on the assignee are not enforceable where they arise solely by virtue of the debtor's financial condition or the court-ordered assignment).

Because the statutory provisions were enacted only relatively recently, courts have not had many opportunities to interpret the provisions in reported decisions. As a result, there remains some uncertainty as to how the provisions will be applied (*e.g.*, (1) what constitutes a "monetary default", (2) exactly what rights and obligations are "not assignable by their nature", and (3) when it is appropriate for a court to assign rights and obligations to a specified person).

What is very clear is that counterparties that do not receive proper notice of the application to approve the assignment may not be bound by the assignment and may be permitted to terminate the contracts, based on the insolvency of the assignor. Purchasers who intend to benefit from the assignment of such contracts must take care to ensure that proper notice is given.

[*Editor's note*: **Adam Maerov** is a Partner in the Corporate Restructuring Group of McMillan's Calgary office. His practice includes all aspects of bankruptcy and insolvency law, including workouts, reorganizations, bankruptcies, receiverships, liquidations, and security enforcement. Adam has been recognized for several years by *Chambers Global: The World's Leading Lawyers for Business* and as a Lawyer to Watch by Lexpert.

Mitchell Allison is an Associate in the Business Law Group in the firm's Calgary office. His practice includes a broad range of general corporate transactions, including commercial loan and real estate transactions, and the performance of due diligence. Mitchell joined McMillan as a summer student in 2012 and completed his articles with the firm in 2014.]

---

1 *Barafield Realty*, [2014] B.C.J. No. 1049, 2014 BCSC 945.
2 *CCAA*, R.S.C. 1985, c. C-36.
3 *BIA*, R.S.C. 1985, c. B-3.
4 *CCAA*, *supra* note 2, s. 11.3; *BIA*, *supra* note 3, s. 84.1.