Eligible Financial Contracts vs. Insolvency: Round II

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I. INTRODUCTION

The importance of complex financial instruments such as swaps, forwards and other derivatives[1] (referred to in Canadian insolvency legislation as "Eligible Financial Contracts", or "EFCs") to the Canadian and global economies has increased dramatically in the last two decades. In response to representations by the International Swaps and Derivatives Association Inc.(ISDA),[2] the Canadian Bankers' Association (CBA)[3] and others, material amendments

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1 Derivatives are contracts, the value of which is determined with reference to or derived from some underlying variable such as currency, commodities, equities, indexes, weather, freight or credit quality. The value of such contracts is that they enable businesses to hedge against risk of an adverse change in a material factor in their business.

2 ISDA is the largest global financial trade association, by number of member firms, and represents participants in the privately negotiated derivatives industry. ISDA was chartered in 1985 and has over 815 member institutions, including most of the world's major institutions that deal in privately negotiated derivatives, from 56 countries. These include 40 Canadian members, which include financial institutions, energy companies, pension funds and others (International Swaps and Derivatives Association, Inc., *About ISDA*, online: <http://www.isda.org>).

3 Established in 1891, the CBA is the main representative body for banks in Canada and the country's oldest industry association. All chartered banks are eligible for membership and currently all domestic and virtually all foreign banks doing business

were made to Canada's two principal insolvency statutes, the *Bankruptcy and Insolvency Act*[4] and the *Companies' Creditors Arrangement Act*[5] (collectively the "Acts").[6] These amendments, and further proposed amendments to the legislation[7], raise issues concerning the appropriate balance between the economic and social policy objective of facilitating the restructuring of insolvent businesses for the benefit of all stakeholders on one hand and the importance of the legal certainty necessary to preserve the efficiency and liquidity of the capital markets on the other.[8]

In the 1990s, following U.S. legal developments, the Canadian federal government was persuaded to amend federal insolvency laws to provide for special treatment of EFCs. It was expressly provided that in reorganizations the solvent counterparty could not be stayed from terminating and netting EFCs. Amongst other things, these changes validated Canadian financial institutions assessing risk and allocating capital to EFCs based upon their net, marked-to-market exposure.

These amendments gave rise to some litigation over the issue of what is an EFC, or put another way, what contracts qualify for the special treatment afforded to EFCs. That issue has not been particularly controversial with respect to interest rate derivatives or foreign exchange contracts. However, the Courts have struggled with the question of how to determine whether a contract made in respect of a commodity qualifies for the special EFC treatment.

In 2007, once again following the lead of other jurisdictions, the Canadian federal government made additional amendments to its insolvency legislation to further enhance the status of EFCs. In particular, it extended the carve out from the insolvency stays, so that in addition to being able to terminate and net, a counterparty can also enforce security over financial collateral held as security for its swap exposure. In addition, the amendments reduce the risk of the pledge of such collateral as security for an EFC being attacked as an unjust preference and prohibit the Court from granting priming liens over that collateral. The further enhancement of the status of EFCs will create additional heat over the debates about what is or is not an EFC.

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in Canada are members (Canadian Bankers Association, *About Us*, online: <http://www.cba.ca/en/about_us.asp>).

4 R.S.C. 1985, c. B-3 (BIA).

5 R.S.C. 1985, c. C-36 (CCAA).

6 *The Budget Implementation Act, 2007* (*infra*, note 20) received royal assent on June 22, 2007.

7 Bill C-55 (*infra*, note 19) received royal assent on November 25, 2005. It has not yet been proclaimed into force.

8 The need for greater certainty around the treatment of EFCs in insolvencies was recognized by Mr. Justice Farley in *Androscoggin* (*Infra*, note 36 at para. 15). Justice Farley noted in passing that it would be of assistance "if the amendments arising out of the current 5 year review ([at the time] 3 years overdue) refined the definition of EFC so that there might be more certainty for future matters".

The other key change in the 2007 amendments is that they authorize the replacement of the existing statutory definitions of EFCs contained in the legislation with a new definition fixed by regulation.

The purpose of this paper is to discuss the implications of the 2007 amendments in light of the Canadian EFC experience and in light of stalled 2005 general amendments to Canada's insolvency laws.

II. POLICY OVERVIEW

Issues around the treatment of derivatives in insolvency proceedings have been the subject of considerable thought, commentary and debate by market participants, professionals, Parliament and the courts in recent years.[9] The debate has played itself out through the enactment of statutory exemptions to the stays of proceedings contemplated under Canadian insolvency laws and in more recent judicial consideration of the scope of those exemptions. In virtually all Canadian insolvency proceedings, the stay of proceedings against a debtor and its property helps to preserve the status quo for a period of time so that proceedings can be taken for the well being of the debtor and its creditors without any creditor obtaining an advantage over others.[10] In the interest of preserving the status quo, Canadian courts have consistently held that counterparties to executory contracts are stayed from terminating those contracts.[11] The same stays of proceedings have also prevented secured creditors, including, until recently, counterparties to derivative transactions, from realizing against collateral in court-supervised restructurings.

Participants in the derivatives market claim that uncertainty around the ability to enforce EFCs in an insolvency represents a material risk to the efficiency, stability and liquidity of the capital markets that depend on such instruments. In particular, advocates of enforcement of such contracts against insolvent debtors note that:

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9 "Derivative contracts have become increasingly popular as a legitimate method of managing risk. It 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 non-major financial corporations in Canada (and having international links) should not be dealt with in such a manner as to seriously affect their efficiency." (*Confederation Treasury Services Ltd. v. Hees International Bancorp Inc.* (1997), 45 C.B.R. (3d) 204 (Ont. Gen. Div. [Commercial List]) at para. 48, affirmed (1998), 1998 CarswellOnt 4421 (Ont. C.A.)).

10 L. W. Houlden, G. Morawetz and J. P. Sarra, *Bankruptcy and Insolvency Law of Canada*, looseleaf, 3rd ed. (Toronto: Carswell, 2005) at N§16(1); *Northland Properties Ltd., Re* (1988), 73 C.B.R. (N.S.) 141 (B.C. S.C. [In Chambers]), *Sairex GmbH v. Prudential Steel Ltd.* (1991), 8 C.B.R. (3d) 62 (Ont. Gen. Div.).

11 *Norcen Energy Resources Ltd. v. Oakwood Petroleums Ltd.* (1988), 92 A.R. 81 (Alta. Q.B.).

- the Basel Capital Accord provides that financial institutions will only be entitled to capital relief with respect to the collateral they hold if the legal mechanism by which the collateral is pledged or transferred ensures that the institution has the right to liquidate and take possession of the collateral in a timely manner;[12]
- without adequate assurance of enforcement rights, creditors must assess risk exposure on a gross basis and compensate for the increased risk by charging higher rates and reserving additional capital;[13] and
- because the very essence of eligible financial contracts is the mitigation of risk, if counterparties are forced to assume new insolvency risk, the benefits of entering into an EFC may not be available.[14]

There is also a concern that, to the extent that a legislative regime in one country sets out a narrower or less certain regime for enforcement in insolvencies, financial institutions in that country will be at a disadvantage relative to competitors in other countries. Market participants will simply be inclined to deal with counterparties in jurisdictions whose legal frameworks provide for more liberal enforcement.[15] In submissions to Industry Canada, the ISDA expressed the concern that if the Canadian legal framework does not remain competitive with frameworks in other jurisdictions (particularly the United States and Europe), Canadian financial markets will suffer.[16]

When the Eligible Financial Contract exemptions were first enacted in the BIA in 1992, Parliament recognized that the market was evolving with respect to new products and provided for the inclusion of additional types of transaction by regulation. However, no agreements were ever prescribed even as the variety of instruments in the market expanded considerably.

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12 Basel Committee on Banking Supervision, *Consultative Document – The New Basel Capital Accord*, online: Bank for International Settlement <http://www.bis.org/bcbs/bcbscp3.pdf>.

13 Ezgi Kaya, *Derivatives Contracts in Insolvency*, online: Insolvency Institute of Canada <http://www.insolvency.ca/docs/writingAwards/2006/Derivatives%20Contracts%20in%20Insolvency.pdf>, at 8.

14 Insolvency risk is generally only a risk with respect to over-the-counter derivatives which are direct contracts between two parties, as opposed to exchange traded derivatives transactions under which the obligations are those of a clearing agency.

15 Margaret E. Grottenthaler & Philip J. Henderson, *The Law of Financial Derivatives in Canada*, looseleaf (Toronto: Thomson Canada Limited, 2003) at 5.1.

16 A Directive of the European Parliament implemented by all member states of the European Union and four non-member states removes any stay risk or other restrictions on enforcing security in insolvency proceedings, as well as a removal of such collateral from the anti-avoidance provisions of insolvency legislation. Similar rules exist under U.S. law.

The 2007 amendments were motivated by a perceived failure of the Canadian insolvency framework to keep pace with the evolution of financial instruments. Parliament appears to have accepted this perceived inadequacy and has attempted to address the issue both as part of, and independently of, a broader effort at insolvency law reform.

While Canada is generally viewed as a "netting friendly" jurisdiction, uncertainty over which contracts constitute EFCs appears to have concerned some market participants. At the same time, others (particularly insolvency professionals) have argued that the less detailed provisions in Canadian legislation are more likely to inappropriately exempt contracts that should be subject to the stay. It has also been suggested that the failure of Canadian insolvency statutes to keep pace with new instruments had created uncertainty around whether long-term supply contracts, margin loans and a range of new products not envisaged during previous rounds of insolvency law reform constitute EFCs.

Another critical issue for participants in the derivatives market is the ability to exercise enforcement rights against financial collateral (known as credit support) in a timely fashion.[17] The ability to enforce against such collateral in spite of a stay of proceedings is available in the United States, Australia and the United Kingdom. Advocates of amendments under Canadian law to permit such enforcement pointed out that collateral is a critical component of derivatives contracts and that counterparties depend on their ability to enforce their rights on a timely basis in order to manage both risk and capital appropriately. It was argued that there is simply no reason for such parties to accept any risk that these provisions will not be enforceable or are at risk of being primed by Court ordered charges in a receivership or restructuring when insolvency regimes in other countries do not create such a risk.[18] A final issue involves the risk of claw-back under federal and provincial preference legislation which can be contrasted against the safe harbour provisions included in the U.S. Bankruptcy Code. The previously existing claw-back risk under Canadian law was viewed by some market participants as unacceptable.

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17 Letter to Industry Canada from ISDA dated August 31, 2005, "Bill C-55 - Amendments to the *Bankruptcy and Insolvency Act* and *Companies' Creditors Arrangement Act*," online: International Swaps and Derivatives Association, Inc. <http://www.isda.org/speeches/pdf/Commtletteramendbankrupt083105.pdf> at 4.

18 Court-ordered charges that secure the fees and costs of insolvency professionals, indemnification obligations to directors, post-filing debtor in possession financing and other amounts are common in receivership proceedings or CCAA restructurings. It is not uncommon for such charges to rank in priority to pre-existing security.

III. STATUTORY AMENDMENTS

In this article, we describe the amendments to the BIA and CCAA enacted pursuant to Bill C-55[19] and the *Budget Implementation Act, 2007*[20]. This article also considers Regulations that expand the scope of the definition of Eligible Financial Contracts which were gazetted in November, 2007.[21]

EFCs were originally defined in s. 65.1(8) of the BIA pursuant to the 1992 BIA amendments and were added to the CCAA in 1997. With only minor amendments, that definition remained until the recent amendments.[22]

"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

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19 Bill C-55, *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*, 1st Sess., 38th Parl., 2005 (assented to 25 November 2005), S.C. 2005, c. 47.

20 S.C. 2007, c. 29 [*Implementation Act*].

21 *Eligible Financial Contract General Rules (Companies' Creditors Arrangement Act)*, SOR/2007-257; *Eligible Financial Contract General Rules (Bankruptcy and Insolvency Act)*, SOR/2007-256.

22 The *Implementation Act* moved the definition of EFCs from ss. 11.1(1) and 65.1(8) of the CCAA and BIA, respectively, to s. 2 of each of the respective acts.

(n) any agreement of a kind prescribed.[23]

As is demonstrated above, the Acts defined EFCs by listing qualifying transactions rather than outlining the characteristics necessary to classify a transaction as an EFC. Paragraph (j) of the definition stated that "any derivative, combination or option in respect of, or agreement similar to" a qualifying transaction elsewhere listed in the definition was itself a qualifying EFC. Parties to a contract that was not explicitly listed as an EFC were therefore required to examine the list of qualifying transactions and reason by analogy to determine whether the contract in question qualified as an EFC. This uncertainty was further aggravated by the rapid evolution in the derivatives market. As new products were introduced into the market, the list of qualifying transactions in the statutory definition quickly become outdated. The Courts were left to draw their own conclusions about what the unifying characteristics of the list were.

The *Implementation Act* made several amendments to the treatment of EFCs in the insolvency context. Among the alterations was a change to the definition of EFC. The *Implementation Act* amends the definition of EFC under the Acts to "an agreement of a prescribed kind".[24] On November 28, 2007 the federal government published final regulations that provide the new definition of EFC. The regulation published under the CCAA is listed below. Identical provisions, except for the name of the act under which it is to be prescribed, were established for the BIA, *Canada Deposit Insurance Corporation Act* and *Winding-Up and Restructuring Act*.

1. The following definitions apply in these Rules.

"derivatives agreement" means a financial agreement whose obligations are derived from, referenced to, or based on, one or more underlying reference items such as interest rates, indices, currencies, commodities, securities or other ownership interests, credit or guarantee obligations, debt securities, climatic variables, bandwidth, freight rates, emission rights, real property indices and inflation or other macroeconomic data and includes

(*a*) a contract for differences or a swap, including a total return swap, price return swap, default swap or basis swap;

(*b*) a futures agreement;

(*c*) a cap, collar, floor or spread;

(*d*) an option; and

(*e*) a spot or forward. (*contrat dérivé*)

"financial intermediary" means

23 *Supra*, note 4, s. 2 as rep. by *Implementation Act, supra* note 20, s. 91(2); *Supra*, note 5, s. 2 as rep. by *Implementation Act, supra*, note 20, s. 104(2).

24 *Supra*, note 20, ss. 91(2), 104(2).

(*a*) a clearing agency; or

(*b*) a person, including a broker, bank or trust company, that in the ordinary course of business maintains securities accounts or futures accounts for others. (*intermédiaire financier*)

2. The following kinds of financial agreements are prescribed for the purpose of the definition "eligible financial contract" in section 2 of the *Companies' Creditors Arrangement Act*:

(*a*) a derivatives agreement, whether settled by payment or delivery, that

(i) trades on a futures or options exchange or board, or other regulated market, or

(ii) is the subject of recurrent dealings in the derivatives markets or in the over-the-counter securities or commodities markets;

(*b*) an agreement to

(i) borrow or lend securities or commodities, including an agreement to transfer securities or commodities under which the borrower may repay the loan with other securities or commodities, cash or cash equivalents,

(ii) clear or settle securities, futures, options or derivatives transactions, or

(iii) act as a depository for securities;

(*c*) a repurchase, reverse repurchase or buy-sellback agreement with respect to securities or commodities;

(*d*) a margin loan in so far as it is in respect of a securities account or futures account maintained by a financial intermediary;

(*e*) any combination of agreements referred to in any of paragraphs (*a*) to (*d*);

(*f*) a master agreement in so far as it is in respect of an agreement referred to in any of paragraphs (*a*) to (*e*);

(*g*) a master agreement in so far as it is in respect of a master agreement referred to in paragraph (*f*);

(*h*) a guarantee of, or an indemnity or reimbursement obligation with respect to, the liabilities under an agreement referred to in any of paragraphs (*a*) to (*g*); and

(*i*) an agreement relating to financial collateral, including any form of security or security interest in collateral and a title transfer credit support agreement, with respect to an agreement referred to in any of paragraphs (*a*) to (*h*).[25]

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25 *Supra*, note 21.

Because the definition will be within the regulations, the government will be able to more easily update it as the market adopts new risk management products. The definition also has the virtue of explicitly listing several instruments that, despite becoming relatively common in recent years, are not included in the statutory definition.[26] The regulations provide some guidance as to be less dependant upon the common characteristics of EFCs. Parties to a type of contract not explicitly listed will therefore be less dependant upon examining the list of qualifying transactions and reasoning by analogy to establish whether the transaction in question is covered by the definition.

Since the 1990s, EFCs have been granted exemptions from insolvency rules that prohibit the termination and netting of contracts. The *Implementation Act* extends the special treatment afforded to the contracts by granting further privileges to protect creditor rights to financial collateral held in relation to an EFC.

The *Implementation Act* amended the BIA and CCAA to permit counterparties to an EFC to realize on the financial collateral of an insolvent counterparty.[27] As with the exceptions regarding termination and netting, the new provisions do not grant a counterparty a right to deal with financial collateral, but instead exempt a party from stays that would otherwise restrict existing contractual rights to deal with financial collateral. The *Implementation Act* provides further protections for financial collateral by mandating that it not be subject to a priming charge. The Acts were each amended to provide that no order may be made that would have the effect of subordinating financial collateral.[28]

Notwithstanding the above, it is possible that further amendments to the BIA could limit the scope of these protections. Bill C-55 was given Royal Assent on November 25, 2005 but has not yet been proclaimed into force. If the Act, as subsequently amended by the *Implementation Act*, is proclaimed into force, then further risks to financial collateral will be introduced. In particular, Bill C-55 introduces statutory priorities for unpaid wages and pension deficiencies that provide no exemption for financial collateral.[29] It is currently unknown if and when Bill C-55 will be proclaimed into force.

The privileged treatment of collateral held in relation to an EFC is limited by the definition of "financial collateral" within s. 2 of each of the Acts. This definition limits the types of collateral that may be held by counterparties hoping to benefit from the above exceptions for financial collateral.

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26 For example, credit derivatives and weather derivatives are expressly included in the EFC definition.

27 *Supra*, note 4, s. 65.1(9)(b); *Supra*, note 5, s. 11.1(3)(b).

28 *Supra*, note 4, s. 88; *Supra*, note 5, s. 11.1(6).

29 *Supra*, note 19, ss. 81.3-81.7.

"financial collateral" means any of the following that is subject to an interest, or in the Province of Quebec a right, that secures payment or performance of an obligation in respect of an eligible financial contract or that is subject to a title transfer credit support agreement:

(a) cash or cash equivalents, including negotiable instruments and demand deposits,

(b) securities, a securities account, a securities entitlement or a right to acquire securities, or

(c) a futures agreement or a futures account.[30]

Many derivative contracts provide collateral on a mark-to-market basis. Contracts that deal with collateral using this structure require varying amounts of collateral to be posted as security depending on the potential payment that would be required should the contract be terminated at any given moment. This means that, pursuant to the contract, collateral could regularly pass between the parties in order to satisfy the collateral requirements.

A consequential concern for ISDA, and counterparties to EFCs more generally, was the risk that transfers of financial collateral could be characterized as fraudulent preferences and therefore subject to claims by a trustee in bankruptcy.[31] Of particular concern was the presumption in s. 95(2) of the BIA that a payment having the effect of preferring one creditor over another was made with the intention of granting a preference to the former creditor unless evidence establishes otherwise.

In response to fears that transfers of financial collateral could be presumed to be fraudulent preferences, the *Implementation Act* added paragraph 95(2.1)(b) to the BIA. The provision creates a safe harbor by declaring that the presumption in s. 95(2) would not apply to "a transfer, charge or payment made in connection with financial collateral and in accordance with the provisions of an eligible financial contract".[32] This therefore protects counterparties to an EFC from having a transfer of financial collateral pursuant to the terms of an EFC from being presumptively characterized as a fraudulent preference.

30 *Supra*, note 4, s. 2; *Supra*, note 5, s. 2.

31 Letter to Industry Canada from ISDA dated June 7, 2004, "Federal Insolvency Law Reform: Report of Industry Canada on the Operation and Administration of the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*," online: International Swaps and Derivatives Association, Inc. <http://www.isda.org/speeches/pdf/CommentLtrIndustryCanJune72004.pdf> at 6-7.

32 *Supra*, note 4, s. 95(2.1)(b).

IV. INTERPRETATION OF PREVIOUS STATUTORY EFC DEFINITION

Under the previous statutory definitions, Canadian Courts have struggled to articulate a principled and objective distinction between those commodity contracts that constitute Eligible Financial Contracts and what might be thought of as plain vanilla long-term commercial supply contracts where the product to be supplied happens to be a commodity. The Courts were cognizant of the fact that if the definition of Eligible Financial Contracts was too broadly construed, the exemption from the stay of proceedings could inappropriately impair the ability of insolvent debtors to restructure. For example, in *Blue Range*, Justice LoVecchio noted that Eligible Financial Contracts are the exception and not the rule in the CCAA and that courts should be careful about readily expanding what is within the ambit of the term.[33] On the other hand, Canadian courts have also understood the importance of not unduly restricting the application of the exemptions enacted by Parliament.[34]

The jurisprudence that has evolved created some uncertainty around (i) the presence or absence of certain "hallmarks", (ii) whether a commodity contract could, or was intended to be, performed by way of physical delivery rather than financial settlement, and (iii) the fairness of the outcome to the parties to the contract.

In the first reported decision by a Canadian appellate court on the meaning of forwards or other commodity contracts, as used in s. 11.1(1)(h) of the CCAA, the Court of Appeal of Alberta rejected the trial Court's conclusion that Eligible Financial Contracts must be financially-settled. The Court held that such a distinction was not justified by the words of the legislation and would exclude a significant portion of the derivatives market.[35] The Ontario Court of Appeal subsequently held in *Androscoggin*[36] that an Eligible Financial Contract may provide for physical settlement so long as it serves a financial purpose unrelated to physical settlement.[37] The Court referred to the forward commodities contracts in *Blue Range*, which managed the risk of fluctuating

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33 *Blue Range Resource Corp., Re* (1999), 245 A.R. 172 (Alta. Q.B.) at para. 53, leave to appeal allowed (1999), 1999 CarswellAlta 809 (Alta. C.A.), reversed on other grounds (2000), 266 A.R. 98 (Alta. C.A.).

34 *Blue Range Resource Corp., Re* (2000), 266 A.R. 98 (Alta. C.A.) at para. 33 [*Blue Range*].

35 *Blue Range Resource Corp., Re* (2000), 266 A.R. 98 (Alta. C.A.) at para. 40.

36 *Androscoggin Energy LLC, Re* (2005), 75 O.R. (3d) 552 (Ont. C.A.) at para. 15 [*Androscoggin*].

37 In so holding, the Ontario Court of Appeal overturned the conclusion of the Chambers Judge that physically settled contracts could not constitute forwards or other commodity contracts for the purposes of the CCAA (*Androscoggin Energy LLC, Re* (2005), 8 C.B.R. (5th) 1 (Ont. S.C.J. [Commercial List]) at para. 10).

commodities in a volatile market as examples of contracts having a financial purpose.[38]

The principle that contracts that provide for physical delivery should not be automatically ineligible for EFC treatment was supported on various grounds including:

- transactions entered into for financial hedging purposes often contemplate physical delivery;
  - spot contracts, repurchase contracts and future and forward commodity contracts, specifically enumerated in the statutory definitions of Eligible Financial Contracts, must be settled by physical delivery;[39]
  - the definition of swaps under the U.S. Bankruptcy Code[40] was expanded in 2005 to include foreign exchange or precious metals spot transactions and in 2006 to encompass commodity spot transactions (provided that such transactions constitute financial market transactions as opposed to ordinary sales of goods) all of which are physically settled;[41] and
  - most commodity exchanges permit physical delivery as an alternative to financial settlement.[42]

ISDA also noted that financial market participants are increasingly active in both cash and physically settled energy sub-markets (as are major energy users) and that any negative occurrence in either sub-market can pass rapidly to the other.[43] Others have noted that, in the face of a more onerous test for physically settled commodity forwards, there may be an incentive for parties to enter into both physically and financially settled confirmations under a single master agreement to increase the chances that termination and netting rights

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38 *Androscoggin Energy LLC, Re* (2005), 75 O.R. (3d) 552 (Ont. C.A.) at para. 14.

39 *Blue Range Resource Corp., Re* (2000), 266 A.R. 98 (Alta. C.A.) at paras. 32-36, *Androscoggin Energy LLC, Re* (2005), 75 O.R. (3d) 552 (Ont. C.A.) at para. 11.

40 11 U.S.C. §§ 101-1532 (2006).

41 Brief and Memorandum of Law for the International Swaps and Derivatives Association as *Amicus Curiae* Supporting Defendant at 12, *In re National Gas Distributors, LLC*, 369 B.R. 884 (Bankr. E.D. N.C., 2007) (No. S-06-00267-8).

42 Jay J. Park, “Dealing with Security of Supply Issues in Natural Gas Sales Contracts”, *Natural Gas Sales Contracts*, Toronto: Insight Press, 1999, cited in Evelyn H. Biery *et al*, “Treatment of Forward Contracts in Insolvency Cases: A Comparison of US and Canadian Law” in Janis P. Sarra, ed., *Annual Review of Insolvency Law, 2004* (Toronto: Thomson Carswell, 2005) 59 at 95.

43 *Supra*, note 41.

will be available in the insolvency context.[44] There would not appear to be any benefit to encouraging such distortions in behaviour. The new definition of EFCs includes derivatives agreements, "whether settled by payment or delivery".

The trial Courts in *Blue Range* and *Androscoggin* may have focussed on the distinction between physically and financially settled agreements because of the view that the inclusion of all commodity contracts within the definition of Eligible Financial Contracts is inconsistent with the restructuring objectives of the CCAA. Advocates of the financial purpose test adopted by the Court of Appeal in *Androscoggin* may have a similar concern. Some suggest that whether a contract constitutes an Eligible Financial Contract should depend on the primary intention of the transacting parties taking into account their nature and historical and actual conduct under the agreement in question.[45] In other words, whether or not the parties dealing with the commodity are doing so primarily to arrange for the supply and delivery of the commodity in question.[46] Others have criticized such an approach as being subjective and either meaningless or impossibly vague.[47] Such critics also note that any physical forward commodity contract that establishes a forward price has a financial management aspect in that it allows a party to manage the risk of price fluctuations.[48]

To deal with the perceived risk that inclusion of physically settled agreements in the definition of Eligible Financial Contracts would defeat the purpose of the CCAA. The Court of Appeal in *Blue Range* outlined a conception of "commodities" that would limit forward commodities contracts to those dealing with fungible commodities that trade in a liquid and volatile market. According to the Court, that conception would remove from the ambit of the definition of an Eligible Financial Contract, contracts for commercial merchandise and manufactured goods which neither trade on a volatile market nor are completely interchangeable for each other.[49] Implicit in this approach is the recognition that, where a spot market is available that can ensure supply, commodity contracts are essentially financial assets as physical deliveries are not required in order to effect a restructuring.[50] Critics of the *Androscoggin* decision note that the debtor was treating the contracts as a financial asset of the business

44 Sean F. Dunphy, Margaret E. Grottenthaler & Samaneh Hosseini, "Eligible Financial Contracts – The Impact of the Androscoggin Energy Decision and Changes to the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act" (Paper presented to the 4th Annual Ontario Energy Contracts Conference, Toronto, January 19-20, 2006) at 8.

45 Rupert H. Chartrand & Robin B. Schwill, "Shades of Blue: Derivatives in Re Blue Range Resource Corp." (2001) 16 B.F.L.R. 427 at 445-446.

46 *Ibid.*

47 Dunphy, *supra*, note 44 at 6.

48 *Ibid.*

49 *Blue Range Resource Corp., Re* (2000), 266 AR 98 (Alta. C.A.) at para. 45.

50 Grottenthaler, *supra*, note 15 at 5.2.2(c).

and selling them. They suggest that where a spot market is available that can ensure supply, all commodity contracts are essentially financial assets and no other indicia of financial character are required.[51] The new definition of EFCs expressly limits the scope of the term to financial agreements.

In *Androscoggin*, the Ontario Court of Appeal identified three characteristics or hallmarks often present in derivatives or risk management agreements. First, derivatives can be 'marked to market', meaning the net present value of the contract may be determined by, among other things, the market price of the underlying interest. Second, derivatives have a determinate price that facilitates hedging. Third, the parties have the ability to terminate and net the contract in the event of insolvency. The Court held that while these elements are useful indicators of whether an agreement has a financial purpose, their presence or absence is not determinative.[52] The Court also considered the context and history of the agreement and held that all factors must be considered together to determine whether an agreement has the character of a derivative or risk management contract. Finally, the Court applied the 'fairness of result' test first articulated by the Court of Appeal of Alberta in *Blue Range*.

One debate that has made its way into the commentary on the appropriate scope of Eligible Financial Contracts but which appears to have played a limited role in the case law involves the weight placed on the identities and businesses of the parties to an agreement. In the United States, only commodity brokers, stockbrokers, financial institutions or securities clearing agencies and forward contract merchants receive the benefit of an exemption from the automatic stay of proceedings imposed by the U.S. Bankruptcy Code for the purpose of terminating and netting under commodity contracts.[53] In its submissions to Industry Canada, the ISDA recommended that the exemptions from stay proceedings should benefit any party to an eligible financial contract and not a particular class of party.[54] Inquiry into the identity of the counterparty along U.S. lines has been discouraged on the basis that it may lead to uncertainty in the context of a fully-integrated energy counterparty.[55] Others however have suggested that, unlike a financial institution which exists to ensure a smoothly functioning market, there is arguably no greater reason for the consumer of a commodity to

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51 Dunphy, *supra*, note 44 at 6.

52 *Androscoggin Energy LLC, Re* (2005), 75 O.R. (3d) 552 (Ont. C.A.) at para. 15. That said, the hallmarks identified by the Court of Appeal in *Androscoggin* were picked up by the Court in *Calpine Canada Energy Ltd., Re* (2006), 19 C.B.R. (5th) 187 (Alta. Q.B.) at para. 17.

53 11 U.S.C. § 362 (2004).

54 *Supra*, note 31 at 4.

55 David W. Mann, "Judicial Treatment of Eligible Financial Contracts and Other Musings" (Paper presented to the 4th Annual Ontario Energy Contracts Conference, Toronto, January 19-20, 2006) at 7.

be exempted from the stay than a consumer of other products.[56] The amended definition of EFCs is not generally restricted to counterparties in specified businesses. However, in order to qualify as an EFC, a margin loan must be in respect of a securities account or a futures account maintained by a financial intermediary.

The Canadian courts have not prescribed a bright-line demarcation of the scope of the definition of an Eligible Financial Contract. Instead, the courts have applied a fairness test, relied on hallmarks and considered whether an instrument may be physically settled or has a financial purpose. This built-in flexibility, preserving the ability of the courts to ensure the exemption of Eligible Financial Contracts, does not interfere with the dominant purpose of the *CCAA* in cases that the courts believe are appropriate. This flexibility is also consistent with the culture that generally governs Canada's approach to reorganizations.

However, this flexible approach leads to uncertainty and has the potential to negatively affect the liquidity of the derivatives market. There is a material policy argument to be made that certainty about the scope of the definition of an Eligible Financial Contract may be as important as the establishment of a definition that precisely reflects the principled distinction between financial instruments and long-term supply contracts. Participants in the derivatives market require clear words that protect the instruments they trade in. Uncertainty over what constitutes an Eligible Financial Contract could have a chilling effect on the willingness of market participants to enter into risk sharing arrangements with Canadian financial institutions. Moreover, the stable, predictable treatment of derivative transactions is necessary to avoid risks to financial markets themselves as a result of the risk that a disruption at one financial institution can cause difficulties at other institutions or in the financial system more broadly.

V. GOING FORWARD

The new definition of EFCs is clearly an effort to respond to market concerns that there is too much uncertainty about which contracts are eligible for the special treatment afforded to EFCs. Given the advantages of that special treatment, it is likely that any definition will give rise to litigation over its interpretation. However, from an insolvency perspective there are two primary concerns about the definition.

The first is a generic concern that if an insolvent debtor purchases or sells "commodities", both suppliers with ongoing supply contracts and customers with ongoing purchase contracts will argue that their contracts qualify as EFCs. For example, they would be motivated to do so whenever the pricing

56 Chartrand, *supra*, note 45 at 438-439.

terms under the contracts are favourable to the debtor. If successful, those claims could impair the debtor's efforts to reorganize.

A second concern relates to the failure to adequately describe the situations where the special treatment of EFCs is appropriate. By way of example, the inclusion of certain margin loan agreements in the definition creates risks. In the investment dealer community, a margin loan is an agreement between a broker and a client that enables the client to purchase securities or futures without paying the full price. The broker takes a security interest in the securities or futures that the client purchases and asks for additional cash or near-cash collateral (commonly referred to as margin) if the value of the securities or futures declines. The intent is clearly to include these types of loans in the EFC definition.

It is arguable that there is not necessarily an inconsistency between the purpose of the CCAA and the termination of dealer margin loan agreements, where funds were advanced by the dealer for the express purpose of acquiring securities and such securities are not fundamental to the operations of a company and its continued existence. The borrower enters into the dealer margin loan agreement to take advantage of the amplified returns associated with leverage. It is arguably inappropriate to transfer the higher risks associated with leverage to a lender who does not share in the upside benefits.

However, the phrase "margin loan" is a term of art and could easily be construed more broadly. For example, among secured lenders, a margin loan agreement is an agreement between a borrower and a lender which is collateralized by securities owned by the borrower. The lender may require either the delivery of additional collateral or the repayment of a portion of the loan principal if the value of the securities declines. This is commonly referred to as posting margin.

This type of loan can involve the pledge of control blocks of public companies. It is not unusual for loans to be made against those shares on a margined basis. In the event that the public company encounters financial difficulties and the value of its shares were to fall, in theory the lender could not be stayed from enforcing its pledge rights by taking control of the reorganization proceeding. This would be true even if the loan secured by the pledge was made directly to the public company itself. This is seen by at least some members of the professional insolvency community as being inappropriate and contrary to Canada's reorganization culture. It is even conceivable that a lender might argue that a revolving loan margined against the value of bank deposits and other financial collateral constitutes an EFC.

The term "margin loan" is vague enough that commercial lenders may attempt to argue that it includes operating loans margined against inventory and accounts receivable. If such a traditional secured loan were to be characterized as an EFC, the lenders would be entitled to seize all the debtor's bank deposits in a reorganization proceeding, including not only the deposits existing at the time of filing but also new deposits made during the course of a reorganization

proceeding. If that right was exercised, the debtor would be unable to continue to carry on business.

However, the inclusion of the phrase “in respect of a securities account or futures account maintained by a financial intermediary”, modifies the reference to margin loan agreement in the amended definition of EFCs and indicates that the drafters intended to limit the scope of the margin loan provision to dealer margin loan agreements.[57] In the interests of promoting greater certainty, it may be prudent to revise the margin loan provision to make it clear that it only applies to a limited set of transactions. Such an approach might limit the provision to refer to an agreement or arrangement in which a financial intermediary extends credit for the purchase or trading of securities by a client of such financial intermediary , which is collateralized in whole or in part by the securities in relation to which credit is extended.

The potential problem concerning the risk of seizure of bank deposits and other forms of cash equivalents is not limited to ambiguity about the meaning of “margin loan agreements”. The proponents of the new definition of EFCs and the expanded rights for EFCs have in mind situations where the securities are specifically pledged pursuant to standard swap documentation to secure a swap position. However, in the syndicated loan market it is common to allow swaps to be entered into that share the same general security agreements and collateral as is held by the syndicated lenders. In those situations it is arguable that under the new rules the swap counterparties could seize all of the debtor’s pre-filing and post-filing financial assets until the swaps are terminated and paid in full. Once again this could prevent a reorganization from proceeding.

What these examples demonstrate is the difficulty of creating a scheme for the special treatment of EFCs that does not create potential problems either for the capital markets or for the reorganization system. In addition to concerns about the scope of contracts that will be entitled to EFC treatment, there are other issues relating to the exercise of the special rights given to EFC holders.

For example, the proposed 2005 amendments to the CCAA and BIA create a general scheme for dealing with executory contracts. That scheme would not apply to EFCs. However, as part of the general scheme, the CCAA is being amended to restrict the types of contingent liabilities that can be

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57 In its submissions to Industry Canada, ISDA referred to statements made in House Report 109-031 on the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (which amended the U.S. Bankruptcy Code) which stated that the concept of “margin loans” was intended to encompass only those loans commonly known in the securities industry as “margin loans” or arrangements where a financial intermediary—a stockbroker, financial institution, financial participant, or securities agency—extends credit in connection with the purchase, sale, carrying, or trading of securities and not other loans that happen to be secured by securities collateral.

compromised by a CCAA plan.[58] It may be that a claim arising after a filing under an ongoing contract that is not terminated during the reorganization proceeding cannot be compromised. This inadvertently creates a problem with respect to EFCs.

This problem arises because a typical swap agreement provides that the insolvency of one party does not automatically terminate the swap. Rather, it gives the counterparty an option to terminate at any time thereafter. It appears that if the swap counterparty decides to defer termination, there may not be means for the debtor to compromise its ongoing exposure under the swap under the CCAA if the 2005 amendments come into force. This would clearly be an unintended result of the amendments.

One might ask why wouldn't the counterparty terminate? A simple example would be situations where the counterparty would actually owe money to the debtor upon termination at the time of filing. It could then be in the counterparty's financial interest to keep the swap position open.[59] Similar incentives might cause the counterparty to defer termination if it held collateral for the swap and was over-collateralized.

The behavioural analysis is further complicated by other common swap agreement provisions. The agreement may purport to provide that the "innocent" counterparty has no obligation to make payments to the defaulting (insolvent) counterparty so long as the default is continuing.

These examples demonstrate that if the swap counterparty elects not to terminate, there is a material risk that the value of the debtor's estate would be impaired during the course of a reorganization proceeding, and it could be difficult or even practically impossible for the debtor to reorganize. The new statutory provisions do not contain any protections for the debtor's estate against contractual terms in swap agreements, or against behaviour of swap counterparties, that could be seen as over-reaching or confiscatory from an insolvency perspective.

Proclamation of the 2005 amendments will have other indirect consequences relating to swaps. One very clear change contained in those amendments is the subordination of equity related claims to the claims of general unsecured creditors. This principle will affect claims under equity derivatives based on the shares of one of the swap parties. If that party becomes insolvent and files for reorganization, any amounts owed by that party under the swap will be subordinated. It has been said that those 2005 amendments (which would bring Canada in line with other jurisdictions) triggered a re-pricing of equity derivatives in Canada.

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58 Subject to certain exceptions, only claims relating to debts and liabilities to which the company is subject on the applicable filing date, or certain claims relating to debts and liabilities incurred prior to such dates, may be dealt with under a plan (*Supra* note 19, s. 131 at s. 19).

59 See *e.g. North America Steamships Ltd., Re* (2007), 32 C.B.R. (5th) 35 (B.C. S.C.).

These examples demonstrate the direct link between insolvency laws and activities in the financial markets. They are not intended as an exhaustive summary of the potential effects of the 2007 amendments or the proposed amendments that are not yet in force or of the issues that may arise as a result of their enactment. What is clear, is that it has not been possible for the issues relating to the treatment of swaps to be fully addressed by the eclectic process of insolvency law reform in Canada.

VI. CONCLUSION

The 2007 amendments to Canada's insolvency laws were made to bring Canadian insolvency rules with respect to EFCs in line generally with the rules of the U.S. and of other nations. Those amendments will inevitably trigger a new round of litigation because they further enhance the status of EFCs.

However, the amendments reflect pressure from the capital markets and are not fully thought out from an insolvency perspective. It is likely that further statutory amendments will be required in order to strike a proper balance between capital markets considerations and insolvency considerations.