

RESTRUCTURING AND DERIVATIVES BULLETIN

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IDENTIFYING ELIGIBLE FINANCIAL CONTRACTS: MORE THAN A FINANCIAL PURPOSE

In recent years, Canadian courts have struggled to clarify the scope of the eligible financial contracts (EFC) exemption from the stay provisions of the Canadian insolvency statutes. At its core, the issue is when is a derivative free from the stay.

In the recent *Calpine Energy* decision, the Court of Queen's Bench of Alberta held that EFCs qualifying for protection from the stay should display the financial characteristics of derivatives or risk management contracts. Rather than providing a bright-line test, the court adopted a flexible approach that may complicate efforts to determine what agreements qualify as EFCs. The decision is consistent with a developing line of Canadian case law.

Enron Capital & Trade Resources Canada Corp. v. Blue Range Resource Corporation

The issue in the earlier *Blue Range* case was whether several long-term natural gas supply contracts were EFCs and, more specifically, whether they constituted forwards or other commodity contracts for the purposes of section 11.1(1)(h) of the *Companies' Creditors Arrangement Act* (one of Canada's two principal restructuring statutes).¹ The Alberta Court of Appeal rejected the lower Court's conclusion that EFCs must be financially-settled, rather than physically-settled contracts. The Court of Appeal held that such a distinction was not justified by the drafting of the legislation, and excluded a significant portion of the derivatives market. The Court of Appeal held that while they may be physically-settled, to qualify as EFCs forward commodities contracts must be for fungible commodities that trade in a liquid and volatile market, and must specify a certain future time and price. The Court of Appeal also applied a 'fairness of result' test by considering whether it would be fair to the parties to characterize their agreement as an EFC.

Re Androscoggin Energy LLC

The Ontario Court of Appeal dealt with a similar issue in *Androscoggin Energy*. Adopting the general principles set out by the Alberta Court of Appeal in *Blue Range*, the Ontario Court held that qualifying EFCs must serve a "financial purpose unrelated to the physical settlement of the contract". The Court referred to the forward commodities contracts in *Blue Range*, which managed the risk of fluctuating commodities in a volatile market as examples of contracts having a financial purpose. Having regard to the long-term gas supply contracts as a whole, the Ontario Court of Appeal held the contracts lacked sufficient hallmarks of a financial purpose to be characterized as EFCs.

Re Calpine Canada Energy Limited

In *Calpine Energy*, the issue was whether or not a Call on Production Agreement (COP Agreement) entered into between Pengrowth Corporation (Pengrowth) and Calpine Canada Natural Gas Partnership (Calpine) was an EFC. The COP Agreement provided Calpine with a right of first refusal to purchase natural gas or oil at market price from Pengrowth, and was entered into as a condition of Calpine's sale of gas and oil producing lands to Pengrowth. The COP Agreement was to remain in effect until the lands no longer produced gas and oil, or until terminated by the parties.

¹ Section 11.1 of the CCAA was imported from section 65.1 of the Bankruptcy and Insolvency Act to harmonize the statutes. It is probable the Courts will treat the provisions similarly.

The Court identified three elements 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 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. 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. As the COP Agreement lacked the first two elements and was entered into as part of the consideration for the sale of oil and gas producing land, the Court held the COP Agreement did not have a financial purpose.

Finally, the Court applied the ‘fairness of result’ test from *Blue Range*. Recognizing that the test is not always easy to apply, the Court held it was unfair to permit the termination of the COP Agreement because it would deprive Calpine of a valuable asset while Pengrowth, which was not hedged in relation to the COP Agreement, would not be in a worse position than any other supplier.

Conclusion

The Canadian courts have not prescribed a bright-line demarcation of the scope of an EFC, and have included a subjective fairness test. This built-in flexibility allows the court to ensure the definition of an EFC does not interfere with the dominant purpose of the CCAA, to facilitate the restructuring of insolvent companies for the benefit of stakeholders generally. However, this flexible approach leads to uncertainty and has the potential to negatively affect the liquidity of the derivatives market.

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The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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