FINANCE

International Financial Products and Services

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I. Critical Safe Harbors Expanded in the New U.S. Bankruptcy Act[a]

While the media coverage relating to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the BAPCP Act)[1] focused on the new consumer bankruptcy provisions, the swaps and derivatives industry quietly celebrated a major victory for its industry that was ten years in the making. The BAPCP Act, effective on October 17, 2005, was welcomed by the financial services industry as it clarifies the treatment of certain types of financial contracts upon the insolvency of a counterparty and, correspondingly, reduces systemic risk and strengthens the competitiveness of American financial markets. A number of amendments were made to the United States Bankruptcy Code, the Federal Deposit Insurance Act (FDIA)[2] and the Federal Deposit Insurance Corporation Improvement Act (FDICIA)[3] through the passage of the BAPCP Act. This article offers a brief summary of the more significant improvements made to the body of U.S. statutes by passage of the BAPCP Act.

A. Clarification of Definition of Financial Contracts

The BAPCP Act expands the safe harbors of sections 555, 556, 559 and 560 in the Bankruptcy Code by enhancing the definitions of forward contract, repurchase agreement, swap agreement, commodity contract, and securities contract. Over the intervening decade, a number of new products developed, and while no one doubted that many if not all were covered by the then-existing Bankruptcy Code, the explicit reference to the new list of products enhances legal certainty. The safe harbor for swap agreements now encompasses:

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a. Contributed by Kimberly Summe. Ms. Summe is the General Counsel of the International Swaps and Derivatives Association, Inc. in New York and Co-Chair of the Financial Services and Products Committee.

1. Bankruptcy Abuse Prevention and Consumer Protection Act, 11 U.S.C. §§ 101-1502 (2005).

2. Federal Deposit Insurance Act, 12 U.S.C. §§ 1811-35 (2005).

3. Federal Deposit Insurance Corporation Improvement Act, Pub. L. No. 102-242, 105 Stat. 2236 (1991).

(1) credit derivatives (including total return swaps); (2) weather derivatives; (3) spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange or precious metal agreements; (4) equity index or equity swaps, options, futures, and forward agreements; and (5) commodity index or commodity swaps, options, futures, or forward agreements. The definition also now includes combinations or agreements or transactions, options, master agreements, and security arrangements meeting certain requirements. The inclusion of credit enhancement agreements was key because those agreements, such as the International Swaps and Derivatives Association (ISDA) Credit Support Annex, are now eligible for treatment as a swap agreement and thus may be terminated, liquidated, accelerated, and netted under the BAPCP Act. Lastly, important language was added that indicated that "any agreement or transaction that is similar to any other agreement or transaction . . . and that is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealing in the swap markets" will be covered by the term swap agreement.[4]

The definition of securities contract was also improved. Prior to adoption of the BAPCP Act, the term included contracts for the purchase, sale, or loan of a security. Under the BAPCP Act, the definition of securities contract was specifically amended to include margin loans, repurchase agreements, and reverse repurchase agreements on any securities and on mortgage loans.

B. Cross-Product Netting

Also important from the industry's perspective was the new definition of master netting agreement. The inclusion of this definition ensures that the termination and close-out netting provisions of cross-product master agreements and "master master" agreements are protected. The BAPCP Act stated that the inclusion of a non-qualifying transaction under a master agreement does not prevent all the other qualifying transactions from being treated as swap agreements, for example. This approach strengthens firms' ability to cross-product net, which in turn leads to better regulatory treatment and risk management improvements.

C. Financial Participant

Prior to the BAPCP Act, the Bankruptcy Code required that the right to liquidate a securities contract, for example, extended only to certain financial participants such as stockbrokers, financial institutions, and securities clearing organizations. The BAPCP Act amended the definition and now permits a broader range of market participants to take advantage of the safe harbor benefits in order to close out their securities and forward contracts, provided the entity is engaged in certain minimum gross dollar value of enumerated transactions. In amending this definition, Congress utilized the definition under the FDICIA, as amended by the Commodity Futures Modernization Act of 2000. The inclusion of clearing organizations was key as it encourages the clearance of derivatives and other types of transactions through a centralized clearing house, thereby lessening systemic risk.

D. The FDIA and the FDICIA

A number of changes were made to the FDIA and the FDICIA when the BAPCP Act was passed. The amendments made to the definitions of the protected transaction types

4. 11 U.S.C. § 101(53B)(A)(ii)(I) (2005).

were conformed to the equivalent definitions in the FDIA, for example. Under the FDIA, "walkaway" clauses are unenforceable in FDIA proceedings. A walkaway clause is defined as a provision that, after calculation of a value of a party's position or of an amount due to or from one of the parties upon termination, liquidation, or acceleration of the qualified financial contract, either does not create a payment obligation of a party or extinguishes a payment obligation of a party in whole or in part solely because of such party's status as a non-defaulting party.

The FDICIA, prior to the BAPCP Act, stated that netting contracts between financial institutions were enforceable. The BAPCP Act expands the definition of financial institution under the FDICIA to include non-U.S. banks, including their branches or agencies. This is an important amendment because the nature of the derivatives business is cross-border in nature and ensures that transactions under a master agreement between a U.S. financial institution and non-U.S. financial institutions are offered protection. In addition, prior to the BAPCP Act, the FDICIA required that a netting contract had to be governed by U.S. law in order to receive the statute's protections. Now, the BAPCP Act expands that netting contract definition in the FDICIA to cover netting contracts governed by non-U.S. law. This means that ISDA Master Agreements governed by English-law are covered by the new protections afforded by the BAPCP Act.

E. Conclusion

The overhaul of the Bankruptcy Code is a welcome development that will strengthen the competitiveness of the U.S. market, particularly for participants in the swaps and derivatives industry, as well as reduce systemic risk through the enhanced legal certainty of the BAPCP Act's provisions. At the time of this writing, it is possible that additional amendments that would, among other items, further broaden the transaction types covered by the legislation to include prepaid forwards, spot commodities, emissions derivatives, and inflation derivatives, may be adopted by Congress. Ensuring the health of the $228 trillion global swaps and derivatives industry is a long overdue victory.

II. Changes to Investment Funds Legislation in Ireland[b]

On June 30, 2005, the Investment Funds, Companies and Miscellaneous Provisions Act 2005 (the IFCMP Act) was enacted.[5] This Act provides, among other things, additional flexibility and new opportunities for the funds industry in Ireland. In the context of investment funds, the following key provisions of the IFCMP Act are particularly welcome: (1) the segregation of liability between individual sub-funds of an umbrella fund established as an investment company; (2) the provision for cross-investment between individual sub-funds of an umbrella investment company; and (3) the provision for the establishment of a non-UCITS common contractual fund (CCF).

b. Contributed by Mark White and Judith Lawless, partners with McCann FitzGerald in Dublin, Ireland. Ms. Lawless is a member of the Financial Services and Product Committee's Steering Committee.

5. Investment Funds, Companies and Miscellaneous Provisions Act, 2005 (S.I. No. 323/2005) (Ir.), *available at* http://www.oir.ie/documents/bills28/acts/2005/a1205.pdf.

A. Segregated Portfolio Companies

Prior to the IFCMP Act, Irish company law provided that, while the assets and liabilities of a sub-fund of an umbrella investment company were attributable to that sub-fund and separate books and records were maintained in respect of each sub-fund, the company remained liable to third-party creditors as a whole. Unless contractually excluded, this enabled a creditor of one sub-fund of the investment company to have recourse to the assets of other sub-funds of the company in the event that the particular sub-fund with which it had contracted was no longer solvent or in some other way had failed to discharge the amount owing in full to that creditor. The risks associated with potential cross-liability between sub-funds are particularly relevant in the context of sophisticated umbrella funds where a sub-fund might employ leverage or otherwise deal in instruments that could lead to an exposure in excess of the value of the assets of that sub-fund. It should be noted that it was already possible to provide for segregation of liabilities between sub-funds of an umbrella unit trust or of a common contractual fund.

The new IFCMP Act provides for segregated liability between the sub-funds of an umbrella fund established as an investment company. This brings Irish funds legislation into line with other jurisdictions such as France, Luxembourg, Bermuda, the Channel Islands, and the Cayman Islands, which already have protected cell legislation. Since the provision for segregated liability between sub-funds derives from statute, it will automatically apply to any new umbrella investment company that is authorized after June 30, 2005.

The IFCMP Act also sets out certain new disclosure requirements that must be met by umbrella investment companies. In addition, the IFCMP Act also provides that certain terms shall be implied into third-party agreements regarding segregated liability.

The new legislation provides that segregated liability will not be available automatically to an umbrella fund that has been authorized prior to June 30, 2005. There is, however, an opportunity afforded to umbrella funds in existence prior to that date to avail of the segregated liability provisions and thereby convert to a segregated portfolio fund. The following are the main requirements that need to be met in this regard: (1) a special resolution must be passed by the shareholders of the umbrella fund; (2) all creditors of the umbrella fund must receive notice in writing of the proposal to convert to segregated liability status; and (3) notice must be published in at least one national newspaper stating the intention of the umbrella fund to avail itself of segregated liability and that an application can be made for a court order to prevent the proposal taking effect. Creditors must make an application within twenty-eight days of receipt of notice by them of the proposal.

The notice of special resolution must be accompanied by audited accounts and a statement of the assets and liabilities of each sub-fund of the umbrella fund—the information should not be more than four months old. Notice must also be delivered to the Registrar of Companies in Ireland.

B. Cross-investment

Until now, Irish company law prevented cross-investment between sub-funds of the same umbrella investment company. The relevant provisions of Irish company law required that the acquisition by an umbrella investment company, on behalf of one sub-fund, of shares in another sub-fund of the same investment company, resulted in the purchase by the investment company of its own shares. The legislation governing Irish investment companies specifically required cancellation of any shares of the company that had been pur-

chased by the company. The new legislation now permits an umbrella investment company to subscribe for shares in other sub-funds in the same umbrella fund.

C. Common Contractual Funds

The European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2003[6] (the UCITS Regulations) facilitated the creation of common contractual funds in Ireland as UCITS only. The IFCMP Act extends this facility to non-UCITS funds. The CCF is essentially a facility whereby investors may pool their resources to enable them to be managed commonly for investment purposes. Importantly, the CCF is treated as being transparent for Irish tax purposes provided certain investor criteria are met. This means that investments made by the CCF are treated in the same way, from an Irish tax perspective, as if the investor had made the investment directly. Accordingly, income of the CCF accruing to the unitholders in the CCF is not subject to Irish tax, nor is there any Irish withholding tax on payments from the CCF to the unitholders.

Because UCITS structures include restrictions, such as those related to investment policy, acceptable asset classes and borrowing restrictions, the attractiveness of the CCF had, until now, been somewhat limited. The availability of a non-UCITS CCF will complete the product range available in Ireland and will permit the establishment of a variety of products, including sophisticated funds with alternative investment policies.

In order for the tax transparent treatment to apply, Irish tax legislation requires that all investors in a CCF must be institutional investors. Individuals are not permitted to invest. In fact, until recent tax changes, only pension schemes could invest in a CCF. It is likely that the CCF will remain most popular with pension funds, given the efficiencies involved in pooling pension fund investments while managing to preserve any tax advantage enjoyed by each investor pension fund.

D. Prospectus (Directive 2003/71/EC) Regulations 2005

The Prospectus Directive was implemented in Ireland on July 1, 2005, by means of the Prospectus (Directive 2003/71/EC) Regulations 2005, S.I. No. 324 of 2005 (the Prospectus Regulations).[7] In summary, the purpose of the Prospectus Directive is to harmonize the requirements for the drawing-up, approval, and distribution of prospectuses for securities that are to be offered to the public or admitted to trading on a regulated market in a European Union (EU) Member State. The Directive provides a passport for the distribution within the EU of securities to which the Directive applies. The Directive provides for a number of exemptions relating broadly to categories of investors and size of offering. Where application is being made for securities to be admitted to trading on a regulated market in an EU Member State, these exemptions do not apply.

In the context of investment funds, the Prospectus Directive applies only to closed-ended funds. While the Prospectus Directive does not itself provide a definition of a closed-ended fund, the rules issued by the Irish Financial Regulator defines a closed-ended fund as being

6. European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2003 (S.I. No. 211 of 2003) (Ir.), *available at* http://www.entemp.ie/publications/sis/2003/si211.pdf.

7. Prospectus (Directive 2003/71.EC) Regulations 2005 (S.I. No. 324 of 2005) (Ir.), *available at* http://www.entemp.ie/publications/sis/2005/si324.pdf.

"a collective investment [undertaking that] does not permit the redemption of its units at the holder's request."[8] Action taken by a fund to ensure that the stock exchange value of its units does not significantly vary from its net asset value is regarded as equivalent to such redemption. Such action does not, however, include the appointment of a market maker or other intermediary to assist in the provision of liquidity to investors on the secondary market.

III. Set-Off and Settlement Obligations within the Brazilian Financial System[c]

The introduction of Provisional Measure 2192-70, of August 24, 2001,[9] made possible the existence of agreements for the set-off and settlement of obligations within the Brazilian Financial System (SFN). The provisional measure charged the Brazilian National Monetary Council (CMN) with publishing the regulation applicable to the matter. Although some agreements were made before the publication of the provisional measure, on the ground of contractual autonomy, there was no guarantee as to their efficacy in insolvency proceedings in the absence of a specific legal instrument addressing the matter. The Provisional Measure 2192-70, of 2001, amended the 1945 Bankruptcy Law to permit set-off and settlement of obligation agreements that satisfy conditions and format regulations to be established by the CMN. CMN Resolution 3039 was published on October 30, 2002. The Resolution regulated the making of agreements for set-off and settlement of obligations within the SFN. The Resolution also, as a condition for efficacy, requires a specific agreement to be registered as a public instrument or, alternatively, provided for in special contractual clause registered with the asset registration and settlement system where the transaction was processed.

In view of the operational difficulties associated with these registration regimes, the CMN decided to improve the provisions regarding set-off and settlement agreements. As a result, the CMN has published CMN Resolution 3263, of February 24, 2005.[10] This regulation establishes, as a condition for efficacy of said agreements, the requirement that a specific agreement should be registered as either a public or a private instrument. In the case of a private agreement, the agreement must be properly registered with the relevant public records office or, alternatively, be registered with the assets registration and financial settlement entity accredited by the Bacen or entity operating the registration of transactions in derivative organized markets, provided that it has been specifically accredited to that end by Bacen or the Brazilian Securities and Exchange Commission. The registration with the public records office or the Bacen accredited system must be made within up to five business days of the date of execution of agreement.

8. Irish Financial Services Regulatory Authority, Interim Rules Issued Under Section 51 of the Investment Funds Companies and Miscellaneous Provisions Act, 2005: Prospectus Rules (July 2005), *available at* www.ifsra.ie/data/in_mark_prospdir/PD%20Interim%20Rules%20July%202005%20-%20Final%20Version.pdf.

c. Contributed by Walter Douglas Stuber and Adriana M. Gödel Stuber. Walter Douglas Stuber is the founding partner of Stuber—Advogados Associados in São Paulo, Brazil and Vice-Chair of the Financial Products and Services Committee. Adriana M. Gödel Stuber is a partner with Stuber—Advogados Associados.

9. Provisional Measure No. 2192-70, of February 24, 2001 (Brazil), *available at* https://www.planalto.gov.br/ccivil_03/MPV/Antigas_2001/2192-70.htm (Portuguese version).

10. CMN Regulation No. 3263, of February 24, 2005 (Brazil), *available at* http://www.stuberlaw.com.br/pdf/Res_3263.pdf.

Another highlight is the newly enacted Law 11101, of February 9, 2005,[11] known as the Company Recovery and Bankruptcy Law that regulates judicial and extrajudicial recoveries and bankruptcy of businesspersons and business companies. By establishing in article 119, item VIII, that, where there is an agreement for set-off and settlement of obligations within the SFN, on the terms of current laws and regulations, the non-bankrupt party is entitled to early termination, in which case it shall be settled as provided in regulation. In addition, any credit right being ascertained in favor of the bankrupt party can be offset against credit rights held by the other party, being that the new law gave stronger legal assurance for the execution of this kind of agreement.

Finally, with a view to improving the transparency requirements of financial institutions, the new regulation now requires that both the existence of an obligations set-off and settlement agreement, as well as their general features, be included in the explanatory notes to the financial statements published by the financial and other institutions accredited by the Bacen. CMN Regulation 3263 further determines that those institutions input and keep current their information on the Bacen's System of Information on Entities of Interest, about the officer responsible for the matters regarding the obligations set-off and settlement agreements.

IV. Update on the People's Republic of China (PRC) Relating to Financial Products[d]

A. RMB Forwards and Swaps

On August 9, 2005, the People's Bank of China (the BOC) published the Circular on Expanding RMB Forward and RMB Swap Business by Foreign Exchange Designated Banks (the Circular).[12] Effective August 2, 2005, the Circular extends permission to qualified domestic and foreign banks to carry out RMB forward and swap business. Before promulgation of the Circular, only the four largest state-owned banks and three PRC domestic banks were entitled to engage in RMB forward business with strict restrictions on the term (a maximum term of 365 days) and pricing. Following the revaluation of RMB announced on July 21, 2005, and the introduction of RMB bond forward transactions on the Inter-bank Bond Market starting on June 15, 2005, the Circular marked yet another landmark development in the fast growing RMB derivative market.

The Circular has made the following significant changes. First, all commercial banks with a licence to conduct RMB-related spot exchange business and a derivative approval (the eligible banks) may engage in RMB forward business. Currently, there are over fifty domestic and foreign banks that have been granted a derivative approval by the China Banking Regulatory Commission, most of which are also licensed to conduct RMB-related spot exchange business. Second, no approval by the BOC is required and an eligible bank only needs to make a filing with the State Administration of Foreign Exchange (SAFE),

11. Law No. 11.101, of February 09, 2005 (Brazil), *available at* http://www.stuberlaw.com.br/pdf/law_11101.pdf.

d. Contributed by Thomas Jones. Mr. Jones is a partner with Allen & Overy in Hong Kong and Vice-Chair of the Financial Products and Services Committee.

12. People's Bank of China, Circular on Expanding RMB Forward and RMB Swap Business by Foreign Exchange Designated Banks, Aug. 2, 2005 (P.R.C.).

which will confirm the filing by notice within twenty working days. For filing purposes, an eligible bank will be required to submit a filing report, its regulations on internal management providing for operational, statistical, risk, pricing, and accounting system, its derivative approval, and other documents as may be required by SAFE. Third, an eligible bank is free to agree with any counterparty on the term and exchange rate of the RMB forward transactions. The restriction of a maximum tenor of 365 days has been removed. An eligible bank may now quote exchange rates on the basis of its business needs and risk management capability that may be more reflective of the prevailing market rates and better customer service. Lastly, the underlying transaction is not limited to loans. A RMB forward transaction may be entered into as a hedge for a range of underlying transactions including all current account item transactions and some capital account item transactions such as registered capital of a foreign invest company. The Circular appears to preserve the pre-existing hedging requirement for RMB forward transactions.

In addition, six months after its commencement of RMB forward business, an eligible bank may also make another filing with SAFE to carry out RMB swap business excluding interest rate swaps. This means that if any of seven PRC banks that have been carrying on RMB forward business, have done so for over six months, it could make a filing with SAFE and conduct RMB swap business immediately.

It is significant to note that an RMB/foreign currency interest rate swap is still not possible under the new regime. Accordingly, it appears that banks will not be able to enter into RMB/foreign currency interest rate swaps (although they could enter into a currency swap with initial exchange and final exchange but without any interim exchange). It is an interesting question if it is open for a RMB/foreign currency interest rate swap to be restructured as a series of RMB forwards which can be carried out under the new regime.

B. China Warrants Market

On July 18, 2005, the Shanghai Stock Exchange and the Shenzhen Stock Exchange simultaneously promulgated their Interim Rules on the Administration of Warrants[13] after approval by China's securities regulator, the China Securities Regulatory Commission. Equity warrants (mostly in the form of subscription warrants) first appeared in China in 1992 before they were prohibited in 1996 by the then securities regulator due to large-scale market irregularity and manipulation. This prohibition has now been lifted, marking the return of equity derivatives to China's domestic market.

One of the primary motives of the rules is to facilitate the reform of state-owned enterprises by integrating non-tradable shares with tradable shares. Shanghai Baosteel Group Corporation was the first to benefit from the regulations. Its reform plan approved on August 3, 2005, by the State Assets Supervision and Administration Commission of the State Council included the issuance by Baosteel's parent company of about 400 million physically settled European-style derivative warrants on the underlying shares of Baosteel, with a tenor of 378 days.

On August 22, 2005, the Baosteel warrants started trading on the Shanghai Stock Exchange—the first warrants to go live on a Chinese exchange after a nine-year ban. Within three days of trading, their market price had surged 67 percent from the price at issue. The

13. Interim Rules on the Administration of Warrants.

volatility witnessed in the price of Baosteel warrants and the related policy issues have been a topic hotly debated in the market. The price of Baosteel warrants, after the initial surge, subsequently plunged dramatically nearly 50 percent from its peak by September 23, 2005. Regardless, many more issuers are now expected to follow suit, with Wuhan Iron and Steel (Group) Corporation and Panzhihua New Steel & Vanadium also likely to issue warrants.

Soon to be added to the fast-evolving legislative framework and much anticipated in the equity warrants market, are the Supplemental Regulations to the Interim Rules on the Administration of Warrants[14] that were passed in principle on September 26, 2005, at the twenty-fifth session of the third meeting of the management commission of the Shanghai Stock Exchange. Once promulgated, the rules will provide more detailed guidelines on issues such as the eligibility of the issuer, initial subscribers and further issue of warrants.

Many questions remain to be answered. Why is there such frenzied exuberance over Chinese warrants? Are Chinese investors ready for investment in warrants? Is the regulatory framework and the market infrastructure of the stock exchange ready to be tested? Will the warrant market in China flourish and follow in the footsteps of neighbouring Hong Kong to become one of the most actively traded markets in the world? One thing is clear—the return of the warrant market, the introduction of bond forwards on the China interbank bond market, and the opening of RMB forwards and swaps, all of which happened in the last few months, show a giant step taken by the Chinese government in accelerating the development and modernization of the nascent RMB derivatives market.

V. Androscoggin Energy LLC—Treatment of Energy Derivatives in a Canadian Insolvency Reorganization[e]

In only the second case heard in Canada on the subject of eligible financial contracts (EFCs), the Ontario Court of Appeal recently handed down a decision in the reorganization of Androscoggin Energy LLC.[15] In so doing they provided guidelines for determining those types of contracts that are not subject to the general stay created pursuant to Canadian insolvency legislation.

An EFC is defined under the Companies' Creditors Arrangement Act (CCAA)[16] to include a comprehensive listing of derivatives instruments commonly used by market participants. Included in the definition are spots, forwards, futures in respect of interest rates, foreign exchange, and commodities as well as master agreements and guarantees relating to such instruments. EFCs enjoy special status in that no order can be granted under the CCAA that stays the right of a non-defaulting party to an EFC to terminate it in accordance with its terms.

Androscoggin operated a co-generation facility in the State of Maine and had entered into long-term gas supply contracts with Pengrowth Corporation, Canadian Forest Oil

14. Supplemental Regulations to the Interim Rules on the Administration of Warrants.

e. Contributed by Thomas F. Pepevnak and David W. Mann. Mr. Pepevnak and Mr. Mann are partners with Fraser Milner Casgrain LLP in Calgary, Alberta. Mr. Mann and Barbara Grossman represented ISDA in the submission of an amicus brief in the Androscoggin Appeal, assisted by Mr. Pepevnak and Bill Jenkins, all of Fraser Milner Casgrain LLP.

15. *In re* Androscoggin Energy LLC, 8 C.B.R. (5th) 1 (Ont. S.C. 2005), *aff'd*, 8 C.B.R. (5th) 11 (Ont. C.A. 2005).

16. Companies' Creditors Arrangement Act, 1985 R.S., ch C-36 (Can.).

Ltd., and AltaGas Ltd. (the Alberta Parties). The contracts were made in 1997 and called for the Alberta Parties to provide set volumes of gas to Androscoggin at an agreed price for a ten-year period. In the intervening period the price of natural gas had risen faster than had been contemplated in the agreements, and the Alberta Parties were out of the money at the time of the Androscoggin filing.

On November 26, 2004, Androscoggin sought protection under Chapter 11 of the U.S. Bankruptcy Code in Maine. Later that same day, Androscoggin made an application to the Ontario Superior Court of Justice under section 18.6 of the CCAA and obtained a stay of proceedings.

Notwithstanding that Androscoggin's filing for protection was an event of default under the gas contracts, the Alberta Parties could not terminate their agreements because Androscoggin continued to pay for the gas it received. In fact, Androscoggin's co-generation facility had ceased operations and Androscoggin was reselling the gas, the profit margin being its major source of revenue while under protection.

The Alberta Parties brought an application before Mr. Justice Farley on January 24, 2005, to have the gas contracts declared eligible financial contracts so that the Alberta Parties could terminate them. Justice Farley denied the motion on two grounds. First, he employed the reasoning used in the only other Canadian case that has discussed EFCs, *Blue Range*,[17] and said that commodity contracts settled by physical delivery of a commodity could not be eligible financial contracts. Second, he found that even if the gas contracts had been considered eligible financial contracts, the agreements could not be terminated by virtue of Androscoggin's continued payments for gas under the agreements.

By way of background, Blue Range Resources, a producer of natural gas, obtained protection under the CCAA on March 2, 1999. Blue Range had a number of long-term natural gas supply agreements with, among others, Enron, Engage, and Duke Energy. These three parties sought a declaration that their supply contracts were eligible financial contracts by virtue of section 11.1(1)(h) of the CCAA, namely that they were "a spot, future, forward or other commodity contract."[18]

Mr. Justice LoVecchio felt otherwise and decided that, since the master gas supply agreements were capable of being settled by physical delivery, they could not be considered eligible financial contracts. Enron, Engage, and Duke Energy appealed, and a nervous gas trading industry sought to intervene through the submissions of the ISDA. Madam Justice Fruman, speaking for the Alberta Court of Appeal, overturned Justice LoVecchio's decision on the basis that restricting forward commodity contracts in section 11.1(1)(h) to cash-settled contracts was contrary to the plain meaning of the section and inconsistent with Parliament's objective of protecting the risk management structure within the derivatives market.

In finding that the physically-settled contracts under consideration in *Blue Range* did constitute eligible financial contracts on the basis that they were forward contracts in respect of a commodity (and therefore a forward commodity contract), the Alberta Court of Appeal found:

> Like the other items in [section] 11.1(1), forward commodity contracts are financial hedges and risk management tools. Interpreting them in the context of the rest of the section requires

17. *In re* Blue Range Res. Corp., 20 C.B.R. (4th) 187 (Alta. Q.B. 2000) *reviewing*, Blue Range Res. Corp., 12 C.B.R. (4th) 173 (Alta. Q.B. 1999).

18. Companies' Creditors Arrangement Act, ch C-36, § 11.1(1)(h).

that they share certain traits. The contracts listed in [section] 11.1(1) deal with units that are the equivalent of any other unit. Therefore commodities must be interchangeable, and readily identifiable as fungible commodities capable of being traded on a futures 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 the forward commodity contracts may be "marked to market" and their value determined. This removes from the ambit of [section] 11.1(1)(h) contracts for commercial merchandise and manufactured goods which neither trade on a volatile market nor are completely interchangeable for each other.[19]

In Androscoggin, the Alberta Parties sought an expedited appeal of Justice Farley's decision because of a hearing scheduled under the Chapter 11 proceedings on February 22 that sought to have the gas contracts assigned. The industry, as represented by the ISDA, sought to intervene in the appeal as it was concerned over the first ground of Justice Farley's reasoning.

The concern to the ISDA and its constituents was the chilling effect this conflict would have on commodity trading. The concern could manifest itself in a likely reduction in credit availability to the derivatives industry, increased capital requirements for some participants (a big concern for the financial institutions trading physical gas), as well as a negative competitive impact in that Canadian counterparties would be less attractive to foreign counterparties whose rights against a Canadian counterparty were unclear at best and unenforceable at worst.

The Ontario Court of Appeal released its decision on February 18, 2005. Justice Weiler, speaking for the court, agreed with Justice Farley's conclusion, although not his reasoning in reaching that conclusion. Of particular relief to the industry and the ISDA, the court agreed that the Alberta Court of Appeal in *Blue Range* was correct in not drawing a distinction between physically settled and financially settled transactions as the basis for characterizing EFCs.

But the court noted that EFCs must serve a financial purpose unrelated to the physical settlement of the contract. The contract should enable the parties to manage the risk of a commodity by providing for the non-defaulting counterparty to terminate the agreement in the event of a filing for protection, to set off or net its obligations, and to re-hedge its position. The gas contracts subject to the appeal did not possess these hallmarks and were therefore not EFCs. The court noted, though, that the mere insertion of such provisions did not guarantee that a contract would be considered to be an EFC. The Court of Appeal also agreed with Justice Farley that under the terms of the contracts before the Court the Alberta Parties were not entitled to terminate them in any event.

Much has been written as to whether Androscoggin has narrowed the decision in *Blue Range*. Arguably, the hallmarks of an EFC mentioned in the Court of Appeal's decision are not new or even startling. As the Court of Appeal said in *Blue Range*:

> Without enforceable termination and netting out provisions, the insolvent company maintains complete control and may repudiate a contract at any time without notice. Because the non-defaulting party cannot count on performance, it cannot effectively re-hedge its risk by entering into an off-setting contract incorporating similar terms. Given the volatility of the market, the non-defaulting party is exposed to excessive and unmanageable risk.[20]

19. *In re Blue Range*, ¶ 45.
20. *Id.* ¶ 29.

The Androscoggin hallmarks are specifically addressed in the Blue Range Appeal Decision. In fact, the Blue Range Appeal Decision, which set out that physically settled EFCs must be contracts for fungible commodities that trade in a liquid and volatile market, is based on these hallmarks. The reason that these elements of the test are required is that the solvent counterparty has immediate rights (i.e., termination and netting) to mitigate its damages (by re-hedging its position) by access to a market where the commodities are traded and that determines market value in a reliable fashion.

Finally, the hallmarks suggested by the Androscoggin Appeal Decision are completely consistent with the EFC provisions found in Canadian insolvency legislation. The EFC provisions do not bestow any rights upon solvent counterparties; they merely prohibit reorganization proceedings from impairing certain rights of the solvent counterparty. But even then, only certain rights of a solvent counterparty are protected, primarily termination and set-off. If the legislation only protects the right to terminate and net out the resulting obligations, then it goes without saying that a contract would have to have these provisions to be considered an EFC.

The rift that was created in this area of law by the Androscoggin Chambers Decision had the potential of being materially disruptive to the derivatives market. The approach taken in the Androscoggin Appeal Decision, which adopts the law used in the Province of Alberta, is a positive step for the derivatives industry and will hopefully inspire the same type of growth in the physically settled derivatives industry since *Blue Range*.