C.A. Action No. 99-18410

IN THE COURT OF APPEAL OF ALBERTA

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, as am.

AND IN THE MATTER OF BLUE RANGE RESOURCE CORPORATION

BETWEEN:

ENRON CAPITAL & TRADE RESOURCES CANADA CORP.

Appellant
(Applicant)

and

BLUE RANGE RESOURCE CORPORATION, HUMBLE PETROLEUM MARKETING LTD., PRICEWATERHOUSECOOPERS INC. in its capacity as Monitor, ROYAL BANK OF CANADA, and FIRST NATIONAL BANK OF CHICAGO

Respondents
(Respondents)

- and -

TRANSCANADA ENERGY LTD. and INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

Intervenors

FACTUM

OF THE INTERVENOR, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

STIKEMAN, ELLIOTT
Barristers & Solicitors
Commerce Court West
53rd Floor, P.O. Box 85
Toronto, Canada M5L 1B9

Sean F. Dunphy
Tel: (416) 869-5662
Fax: (416) 861-0445

Solicitors for the Intervenor,
International Swaps and Derivatives
Association, Inc.

TO: **REGISTRAR, COURT OF APPEAL OF ALBERTA**

AND TO: **Mr. A. Robert Anderson**
Blake, Cassels & Graydon
3500, 855 - 2 St.S.W.
Calgary, AB T2P 4J8
Tel: 260-9600
Fax: 260-9700
For the Appellant
Enron Canada Corp.

AND TO: **Mr. James Eamon**
Code Hunter
1400, 700 – 2 St.S.W.
Calgary, AB T2P 4V5
Tel: 298-1000
Fax: 263-9193
For the Monitor
PricewaterhouseCoopers Inc.

AND TO: **Mr. Howard Gorman**
Macleod Dixon
3700, 400 – 3 Ave.S.W.
Calgary, AB T2P 4H2
Tel: 267-8222
Fax: 264-5974
For Duke Energy Marketing
Limited Partnership

AND TO: **Mr. Larry Robinson**
Miller Thomson
3000, 700 – 9 Ave.S.W.
Calgary, AB T2P 3V4
Tel: 298-2400
Fax: 262-0007
For Engage Energy Canada, L.P.

PART I – STATEMENT OF FACTS

1. The Intervenor, International Swaps and Derivatives Association, Inc. ("ISDA"), adopts the facts as set out in the Factum of the Appellant Enron Capital & Trade Resources Canada Corp. ("Enron"). ISDA also seeks to rely on the additional facts set out below.

2. ISDA respectfully submits that the central issue to be determined on this appeal is whether a transaction which calls for physical delivery of a commodity at a future date at a currently determined price is an "eligible financial contract" within the definition of section 11.1 of the *Companies' Creditors Arrangement Act,* R.S.C. 1985, c.C-36, as amended (the "CCAA").

ISDA

3. ISDA is the global trade association representing the world's major institutions and other leading participants in the privately negotiated derivatives industry, a business which includes interest rate, currency, commodity transactions and equity swaps, as well as related products such as caps, collars, floors and swaptions. ISDA's membership numbers over 425 organizations from around the world. The Canadian members of ISDA include a number of banks, provincial governments and various departments of the federal government.

> Affidavit of Robert Pickel, sworn November 9, 1999 ("Pickel Affidavit"), Supplemental Appeal Book, paras 9, 10 and 11.

4. ISDA's mandate includes the promotion of practices conducive to the efficient conduct of the business of its members in swaps and other derivatives, including the development and maintenance of standard documentation for derivatives, and to foster high standards of commercial conduct among its members. ISDA carries out its mandate in a number of ways, including taking a leading role in formulating and advocating the industry's position on crucial regulatory and legislative issues affecting

both dealers in, and users of, privately negotiated derivatives. Its activities include working with regulators to address policy concerns arising from the evaluation of the business, meeting with policy makers in the world's financial centres, testifying at public regulatory and legislative forums, and the preparation of position papers on, and responses to, regulatory and legislative initiatives.

Pickel Affidavit, paras 9, 10 and 11.

Impact of Decision

5. The decision of the Honourable Mr. Justice LoVecchio dated June 30, 1999 (the "Decision"), in which he defines an "eligible financial contract" as excluding those commodity transactions which by their terms call for physical delivery, will impact the business of financial intermediaries in the energy and precious metals industries, as well as other participants in the Canadian commodity markets, many of whom are Canadian members of ISDA. Two of those greatly affected by the Decision are The Bank of Nova Scotia ("Scotia") and Canadian Imperial Bank of Commerce ("CIBC").

Affidavit of David W. Richardson, sworn November 10, 1999 ("Richardson Affidavit"), Supplemental Appeal Book, para 10.
Affidavit of John Dzisiak sworn November 9, 1999 ("Dzisiak Affidavit"), Supplemental Appeal Book, para 6.

6. It is the position of ISDA that the distinction which the Decision seeks to draw between "physical" and "financial" contracts in the commodity derivatives industry is illusory and that the effect of the Decision is fundamentally to defeat in substantial measure the remedial intent of Parliament in creating a regime to govern "eligible financial contracts" across a broad range of insolvency-related statutory provisions.

7. It is in fact quite common for ISDA members to enter into normal hedging transactions by means of contracts which call for physical delivery of oil, gas and other commodities, such as gold and other metals. Such "physical delivery" contracts are

customarily documented under either ISDA Master Agreements or other agreements similar to them, such as those directly in issue on this appeal. The ISDA Master Agreement and other documentation published by ISDA specifically contemplate the documentation of physically-settled commodity contracts. Consequently, the Decision affects the enforceability of termination and netting rights in an ISDA Master Agreement dealing with commodity forward contracts that by their terms call for physical delivery of the commodity. As such, the Decision in effect carves out for special (and unfavourable) treatment this subset of transactions routinely carried on by ISDA members.

Pickel Affidavit, para 13.

8. The ISDA Master Agreements, authoritative contracts widely used by industry participants, have established international contractual standards governing privately negotiated derivatives transactions that reduce legal uncertainty and allow for the reduction of credit risk through termination provisions and netting of contractual obligations. Ensuring the enforceability of the netting provisions of the ISDA Master Agreement has been, and remains, a key initiative for ISDA, because of its importance in reducing the credit risks arising from the business. ISDA's work in this area has resulted in a series of laws being passed in various countries that ensure legal certainty in those nations. ISDA continues to expand its efforts related to the enforceability of netting provisions, working with the relevant legislative and regulatory representatives in a number of jurisdictions.

Pickel Affidavit, para 12.

9. In its simplest terms, the "eligible financial contract" reforms initiated by Parliament were designed to introduce a basic level of certainty as to the enforceability and operation of hedging and derivative-type contracts in the case of insolvency of a counterparty. The fundamental principle underlying this reform is the recognition of

the inter-connectedness of dealings between counterparties to such agreements and the necessity to allow the contracts to operate so as to permit the unhindered termination of all such related agreements and the netting of the obligations. This in turn allows the solvent counterparty to go back into the marketplace and re-hedge the exposure created by the insolvency and termination.

> Minutes of Proceedings and Evidence of Standing Committee on Consumer and Corporate Affairs and Government Operations on September 11, 1991, p.12:7 and 12:28, Tab 4
>
> Proceedings of the Standing Senate Committee on Banking, Trade and Commerce, First Meeting on Bill C-5 on November 4, 1996, p.13:77, Tab 5
>
> Standing Committee on Consumer and Corporate Affairs and Government Operations First Report on Bill C-22 on October 7, 1991, p. 15:13-15:14, Tab 7

10. As will be seen below, the ripple effect of the Decision, if upheld will be two-fold:

    (i) it will limit the availability of hedging as a risk-management tool to Canadian businesses; and

    (ii) it will impair the competitiveness of Canadian financial institutions in the international marketplace.

Justice LoVecchio's reasons recognized (in paragraph 21) the intention of Parliament to avoid these outcomes, but unfortunately the Decision has achieved this result.

> Dzisiak Affidavit, paras 9 and 12
> Richardson Affidavit, paras 12, 14 and 20
> Reasons for Judgment of LoVecchio J., C.Q.B.A. dated June 30, 1999, Appeal Book Digest, Volume I, p.258.

11. By challenging the twin pillars of certainty of termination and certainty of netting, the Decision ensures that Canadian businesses will have less access to hedging as a risk management tool than their international competitors and that Canadian financial institutions will be handicapped relative to their foreign competitors.

Dzisiak Affidavit, paras 9 and 12
Richardson Affidavit, paras 12, 14 and 20

Why Physically Settled Transactions are "Financial"

12. ISDA's members, such as Scotia and CIBC, participate either directly or indirectly through subsidiaries, in various commodity markets, including natural gas and precious metals, primarily as financial intermediaries. The role of financial intermediaries in these markets is to provide a financial service or product to their customers, namely a service or product that provides price discovery, liquidity and price risk management.

Pickel Affidavit, para 9.
Richardson Affidavit, para 3.
Dzisiak Affidavit, para 3.

13. Financial intermediaries offer cash settled forwards, options and commodities swaps, as well as physically settled commodity products, to provide these benefits to their customers, who may be producers, end-users or other financial intermediaries, in the commodity markets (e.g. gas and precious metals). Participants often match physically settled and cash settled contracts on a transaction by transaction or portfolio basis to minimize financial exposure. In the bullion market, typically producers wish to lock in the highest possible price for future production of bullion, whereas end-users wish to lock in future bullion sources and the lowest possible price for future consumption of bullion. With respect to natural gas, typically producers want upside price exposure but a limited downside; marketers want to protect margins; and local distribution companies, industrials and utilities want certainty as to price. The instruments by which financial intermediaries offer these services frequently provide for physical delivery.

Richardson Affidavit, paras 3 and 17.
Dzisiak Affidavit, para 3.

14. The fact that a contract calls for settlement by delivery of a commodity does not mean that there will be actual delivery of the commodity. For example, in the natural gas market in Alberta, natural gas is not bought or sold in the usual sense of the term by transferring physical possession of the gas. Producers, end-users and intermediaries enter into natural gas transactions under contract but many of the trades simply involve buying and selling the right to take physical delivery of natural gas on a future date. Transactions are settled by "title transfer", whereby participants transact in natural gas, even though they may not have the intention of taking physical control of the natural gas in a pipeline or physically removing it from the pipeline. As a result, the total volume of gas traded far exceeds the amount of natural gas that actually flows through the system. This is like the active trading that takes place in typical financial markets with respect to many other types of assets, such as securities, foreign currency, other commodities. The liquidity of the marketplace is enhanced by this trading capacity.

Richardson Affidavit, paras 4, 5, 6, and 8.

15. By executing such transfers of gas, financial entities, such as CIBC, do not become owners of natural gas, nor do they become end-use purchasers or suppliers. They simply look to access liquidity in the Canadian natural gas markets to improve the pricing of their derivative product line, and offer physically-settled derivative transactions to their customers as a risk management alternative. As well, financial intermediaries like CIBC seek to improve their ability to manage their own risk in the natural gas markets. CIBC does not intend to take physical delivery or possession of natural gas. In fact, it intends to have no net position on delivery day. Financial intermediaries, such as the CIBC, manage their books so that the amount purchased, or transferred into their accounts, offsets the amount of gas sold or transferred out of their accounts. It is critical for these intermediaries to be able to manage their exposure in respect of trades such that the net obligations to deliver and receive natural gas balance to nil at the end of every day during the delivery month.

Richardson Affidavit, paras 7 and 8.

16. Thus while each individual natural gas contract traded may call for physical delivery (and thus be excluded from the "eligible financial contract" regime by reason of the Decision), the net effect of all similar contracts is managed so as to balance to zero. Thus by reason of the risk management activities of one counterparty to a "physical" contract, a "physical" obligation is in effect transmogrified into a "financial" one and the supposed distinction between "physical" transactions and "financial" transactions which formed the foundation of the Decision proves entirely illusory. The effect of the Decision on this system, however, is immediately apparent. Without certainty as to the enforceability of termination rights and netting, a financial intermediary's daily effort to balance its exposure would itself be put at risk. The result would inevitably be both a reduction in access to the market itself (greater credit risk equates to higher entry requirements) and an increase in the cost of doing business in the market (as financial intermediaries pass on the cost of the added risk).

Richardson Affidavit, paras 8, 10-12, 14 and 22

17. Outside of credit considerations, there are very few differences between a master gas purchase agreement settled through the transfer mechanism described above and a futures contract traded on the New York Mercantile Exchange (NYMEX), the Commodity Exchange in New York (COMEX), or the London Metals Exchange (LME). All the exchange traded commodity contracts utilized by the commodity trading desk of CIBC imply physical obligations on maturity. As such, all of these contracts have the possibility of physical delivery and have roughly the same settlement mechanics as the aforementioned gas transfers. Although a futures contract represents an obligation to deliver or accept delivery of an underlying asset, in approximately 98% of futures trades, that obligation is terminated prior to the delivery period through what is known as an "offsetting trade".

Richardson Affidavit, paras 9 and 15.

18. The import of the Decision is also at odds with what takes place on a daily basis in the over-the-counter bullion market in Canada. In this market, producers may sell bullion on a spot or forward basis and the parties to the sale typically have the expectation that the contract will provide for physical settlement. However, physical settlement of transactions is effected through a variety of mechanisms that do not necessarily result in bullion actually being physically transferred from the seller to the buyer. Sometimes a book-entry will be made to the records of the bullion refinery that notes the financial intermediary's entitlement to a given quantity of unallocated bullion. Alternatively, delivery may be effected by means of a book-entry to an unallocated account on the books and records of a member of the London Bullion Market Association (the "LBMA"). In either case, the book-entry equates to a claim (against the refinery or the LBMA member) which applies to the general pool of bullion which the refinery or the LBMA member actually or notionally maintains.

Dzisiak Affidavit, para 4.

19. In the bullion market, Scotia utilizes master netting agreements, such as the ISDA Master Agreement, to document both its physically-settled transactions, and its cash-settled transactions with a particular counterparty. These master netting agreements utilize a close-out netting mechanism which converts the outstanding physical delivery obligations to a cash equivalent and then present values such cash equivalents to a single date. The converted and present-valued physical delivery obligations of one party are combined with the value of such parties other transactions, and then are netted against the value of transactions to the other party which are derived from both physically-settled and cash-settled transactions. Often, Scotia utilizes master netting agreements which are not product specific, meaning that the close-out netting mechanism will operate to net the value of obligations arising in respect of a wide range of transactions, not just those pertaining to bullion, because bullion producers and end-

users are also significant users of other types of over-the-counter derivative financial transactions.

Dzisiak Affidavit, para 5.

Effect of the Decision on Customers

20. If financial institutions are not permitted to terminate and net, then credit lines available to customers, including producers, will decrease, to the competitive disadvantage of these customers. Credit limits are established for each counterparty with which financial intermediaries, such as CIBC or Scotia, transact. Credit usage, or the dollar amount at risk for an intermediary, in the case of derivatives transactions, is a function of the intermediary's exposure under outstanding transactions with a counterparty. Exposure is calculated in part based on the market values of all of the transactions with a counterparty calculated on a net basis. If transactions are governed by enforceable termination and netting provisions, with resulting close-out netting, the exposure and, therefore, the credit usage, can be reflected as a single amount which is the net difference between the "in the money" and "out of the money" transactions.

Richardson Affidavit, para 11 and 14.
Dzisiak Affidavit, para 7 and 9.

21. Conversely, if netting is not allowed, a customer would quickly "use up" its available credit limit since the financial intermediary would have to account for all "out of the money" transactions without decreasing credit usage by giving its customer credit for the "in the money" transactions. The effect will be to limit access to the market for users by reducing in a potentially dramatic way the credit available.

Richardson Affidavit, para 14.
Dzisiak Affidavit, para 9.

22. The fact that financial intermediaries will face different risks in insolvency between contracts that call for physical delivery and those that either provide for cash settlement or which are swaps, means that financial intermediaries will not be indifferent between which contracts it offers its customers. The result will be an increase in the cost of using physical settlement structures or the loss of access to this market.

Richardson Affidavit, para. 12.

Effect of the Decision on Canadian Financial Intermediaries

23. In addition to the impact of the Decision on the credit lines financial intermediaries can make available to customers, there is a separate effect of the Decision on Canadian financial institutions. Financial institutions hedge their own risks in international markets. Parties who deal with Canadian financial intermediaries also want comfort that they can terminate and net for the same reason that Canadian financial institutions want valid termination and netting rights. Because the Decision impacts the similar eligible financial contract definitions in the *Winding-Up and Restructuring Act,* ("WURA") and the *Canada Deposit Insurance Corporation Act* ("CDIC Act"), the Decision will also potentially diminish the credit lines made available to CIBC, Scotia and other Canadian financial institutions by other market participants. It will also put Canadians at a competitive disadvantage in seeking business internationally when their non-Canadian competitors do not face a similar handicap to the enforceability of their termination and netting agreements in their home jurisdictions.

*Winding up and Restructuring Ac*t, R.S.C.1985, c. W-11, as amended, Tab 8
Canada Deposit Insurance Corporation Act, R.S.C.1985, c. C-3, as amended, Tab 1
Richardson Affidavit, para 14.
Dzisiak Affidavit, para 9.

24. The Capital Adequacy Requirements Guideline released by the Office of the Superintendent of Financial Institutions (OSFI) in October 1995 (the "Guideline") requires that Canadian banks meet prescribed capital adequacy standards. Canadian banks (and all other foreign banks subject to BIS capital requirements – some of which participate in the Canadian market) are required to meet both an assets to capital multiple test, as well as a capital to risk-weighted assets and risk-weighted off-balance sheet items test. The Guideline allows banks to net forwards, swaps, purchased options and other similar off-balance sheet derivatives instruments in calculating bank assets, provided that certain conditions are satisfied, including the following:

(a) The bank must have an agreement in place with its counterparty which provides for the netting of all positive and negative mark-to-market values of all transactions with that counterparty in the event of default, bankruptcy, liquidation or similar circumstances; and

(b) The bank must have a legal opinion that confirms that the netting provisions of the agreement would be enforced by a court.

Richardson Affidavit, para 18.
Dzisiak Affidavit, para 10.

25. CIBC, Scotia, and other financial institutions in the Canadian market, have taken the view that transactions which call for physical delivery constitute an "eligible financial contract" under the CCAA and other insolvency legislation, which can be terminated and netted to arrive at a net termination value in a CCAA proceeding. The effect of the Decision is that the conditions for terminating and netting these transactions, with respect to gas, bullion and other commodities where delivery of the underlying commodity may be made will no longer be met for the purpose of the capital adequacy standards, with the result that CIBC, Scotia and other Canadian banks will no longer be able to net positive and negative mark-to-market values of such transactions in calculating assets for the purposes of OSFI's capital adequacy standards. Also, foreign banks who deal with Canadian banks and who are also subject to the BIS

standards will not be able to net for their own capital adequacy requirements, which will impact their ability to deal with the Canadian banks.

> Dzisiak Affidavit, para 11.
> Richardson Affidavit, para 19.

26. Capital is an extremely scarce resource, and its availability determines whether certain businesses can be undertaken at all by a financial institution, or whether existing businesses can be maintained or expanded. Banks employ their capital where its returns are highest. If the Decision stands, then Canadian banks will have to allocate more of their capital to this business. This means "prices" will have to rise to provide an adequate return for this capital or the banks may simply exit the market.

> Richardson Affidavit, para 21.
> Dzisiak Affidavit, para 13.

PART II – ISSUES

27. It is respectfully submitted that the Learned Judge erred in law in interpreting the term "eligible financial contract" within the definition of section 11.1 of CCAA on the basis that so-called "physical contracts" call for physical delivery of gas whereas "financial contracts" do not, such that any forward commodity contracts which call for physical delivery of the commodity are excluded from the definition of an "eligible financial contract."

PART III – LAW

28. The effect of the Decision is to potentially restrict "future, forward and other commodity contract" in subsection 11.1(1)(h) to certain types of contracts, namely commodity swaps that derive value from the price of a commodity, but do not call for delivery of a commodity. In effect, the Decision interprets "commodity contracts" as

contracts based upon the value of a commodity rather than contracts dealing in the commodity itself. It is submitted that this gloss is both unwarranted and wrong in law.

29. The distinction drawn in the Decision between contracts that are *financial* in nature and those which are merely *supply contracts* was an over-simplification of the industry, as it is quite common for parties to hedge risk by entering into contracts that call for physical delivery. In fact, Justice LoVecchio himself recognized that a physical transaction could have a hedging purpose (paragraph 33 of the Reasons for Judgment). It is submitted that to draw a distinction between "financial" contracts and "physical" contracts on the basis of whether the contract calls for physical delivery of gas, or other commodities, is inconsistent with the legislative history of the section, the intention of Parliament and the intentions of the parties entering into these transactions, the plain wording of the CCAA and other legislation, as well as industry practices.

> Reasons for Judgment of LoVecchio J., C.Q.B.A. dated June 30, 1999, Appeal Book Digest, Volume I, pp. 260-261.

The Legislative History of Section 11.1(1)

30. Prior to 1992, neither the CCAA, nor the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c.B.3, (the "BIA"), made special provision for eligible financial contracts. In 1992, Parliament passed a sweeping reform of the former *Bankruptcy Act*. That reform included a provision protecting the right to terminate and net exposures under eligible financial contracts in the context of a BIA proposal proceeding, which otherwise imposes an automatic stay on the termination of contracts by reason of the BIA filing having been made. Prior to its passage, Bill C-22 was scrutinized by the Standing Committee on Consumer and Corporate Affairs. Members of the Canadian Bankers' Association made submissions to the Standing Committee on the issue of eligible financial contracts. The following excerpt is relevant to this issue:

> A recent amendment to Chapter 11 of the U.S. Bankruptcy Code does permit counterparties to terminate or close out hedging

contracts during a stay period if one of these parties becomes insolvent. Similar legislation we feel is needed in Canada to ensure the continued competitiveness of Canadian financial markets and their ability to be part of these contracts when the other party is in fact a U.S. entity or a U.S. citizen.

...

The contracts being discussed, which we have called eligible financial contacts, are, however, important in their limited sphere. They help Canadian and other corporations world wide to manage risks such as changes in interests rates and in currency exchange rates.

Now the markets here are highly volatile and it is important that parties be able to terminate their relationship immediately, if performance by the other party is in doubt, without fear of any stay, to avoid exposure in future market uncertainties.

In the United States the solution we propose has been adopted, as an exception to their very pro-debtor legislation. It has enabled troubled U.S. debtors, and especially those in the financial community, to continue to be able to access these risk-controlling markets at a time when they have needed such protection the most.

In Canada, on the other hand, the proposed stay provisions under the Bankruptcy Act go in exactly the opposite direction. They introduce uncertainty into eligible financial contracts entered into by Canadian corporations. We think this is undesirable, because it would make eligible financial contracts unavailable to weak Canadian businesses at a time when they can least afford to be excluded from the market. It would also effect the position of those business with their competitors in the United States and in other countries, and could lead to some Canadian financial business being done outside of Canada.

Minutes of Proceedings and Evidence of Standing Committee on Consumer and Corporate Affairs and Government Operations on September 11, 1991, p.12:7 and 12:28, Tab 4

31. The CCAA was amended in 1997, in part in order to harmonize the CCAA with the BIA. At this time, the "eligible financial contracts" provisions of the BIA were imported into the CCAA and the theretofore broad discretion which the courts had

assumed to interfere with such contracts (in proceedings such as those involving *Confederation Treasury Services* v. *Hees International Bank Corp. Inc., infra*) was curtailed. It is submitted that the Decision in effect defeats the intent of Parliament in introducing this reform and does so without the benefit of the broad considerations reviewed by Parliament.

> Proceedings of the Standing Senate Committee on Banking, Trade and Commerce, First Meeting on Bill C-5 on November 4, 1996, p.13:77, Tab 5
>
> *Confederation Treasury Services* v. *Hees International Bank Corp. Inc.* (1997), 45 C.B.R. (3d) 204 (Ont. Gen. Div.) Tab 2

Statutory Interpretation

32. It is submitted that the wording of subsection. 11.1(h) of the CCAA given its plain and ordinary meaning and read in the context of the other contracts listed in section 11.1 does not support the "reading in" of the proposed distinction between financial and physical contracts. The plain meaning of terms such as "commodity contract" clearly includes a contract for sale of a commodity – indeed it includes this much more obviously than it includes a contract whose value is derived from the price of a commodity.

33. The Learned Judge focused on the interpretation of the terms "future, forward or other commodity contract" within the definition of section 11.1 of the CCAA. The Court did not, however, look to the other categories in the definition of an eligible financial contract to inform the analysis of the types of contracts to be included in "future, forward or other commodity contracts". It is respectfully submitted that there are other relevant categories within section 11.1, that the Court should have considered such as "a cap, collar or floor transaction" (subsection 11.1(d)), "a commodity swap" (subsection 11.1(e)), and "any derivative, combination or option in respect of, or

agreement similar to, an agreement or contract referred to in paragraphs (a) to (i)" (subsection 11.1(j)).

34. These other categories encompass the typical kinds of transactions involving commodities that would be characterized as "financial in nature", using the terminology employed by LoVecchio J. In fact, the transaction which LoVecchio J. described as the quintessential commodity contract is a "commodity swap" already covered by subsection 11.1(e) of the definition of eligible financial contract. However, if the category of "a spot, future, forward or other commodity contract" is defined as it was by LoVecchio J., then the category would not include any type of contract that would not otherwise fall within the other categories mentioned in subsections 11.1(d), (e), and (j) referred to above. This would result in subsection 11.1(h) "a spot, future, forward or other commodity contract" being redundant.

35. It is respectfully submitted that the category of "a spot, future, forward or other commodity contracts" within section 11.1 of the CCAA must be interpreted as including contracts that call for the physical delivery of a commodity, as all of the contracts that LoVecchio J. would characterize as financial would fall within other categories resulting in 11.1(h) being redundant.

36. As well, the interpretation of LoVecchio J. runs counter to the fact that many of the other types of contracts listed as "eligible financial contracts" in section 11.1 are contracts that call for physical delivery.

37. "Future contracts" trading on an exchange, such as NYMEX, call for the physical delivery of the commodity. The obligation to deliver the commodity is a real obligation even though it may be met by the purchase of an offsetting exchange contract, just as the obligation to deliver the commodity under a forward contract can be. Whether there is the potential for physical delivery cannot be the relevant distinction between a "physical" and "financial" contract because futures are clearly covered by section 11.1 of the CCAA and clearly all futures contracts provide for physical delivery. The only

difference between a forward and a future is that a future is entered into over an exchange. Justice LoVecchio's decision therefore either renders the inclusion of futures in the list of eligible financial contracts meaningless (because there will be no types of futures that meet his definition) or will draw a completely unwarranted and non-sensical distinction between futures and forwards.

38. A "spot commodity contract" is also understood in the industry to refer to a contract to deliver the commodity at the spot price. There is no such thing as a non-physical spot commodity contract.

39. The trading that takes place in the gas and bullion markets is typical of that which takes place in other markets which are clearly financial market places, such as the securities markets and foreign currency markets, and these are contracts which are clearly covered by the definition of an "eligible financial contract" in the CCAA.

40. Repurchase and reverse repurchase agreements and agreements to buy, sell, borrow or lend securities are eligible financial contracts and these transactions clearly require the physical delivery of a security.

41. Including contracts that call for physical delivery of commodities as eligible financial contracts recognizes the direct or indirect relationship between physical and financial contracts that is frequently part of commodity traders' risk management controls. Participants in commodity trading often match physical and financial contracts to minimize financial exposure. It is submitted that, given the interrelationship of physical and financial transactions, it would be unfair and inappropriate to allow the financial side of a transaction rights and protections pursuant to the CCAA that are not available to the physical side. To do so would be to effectively deprive participants in commodity trading transactions of the very risk management protections that the CCAA was intended to provide.

The Intention of the Parties

42. The Learned Judge determined that, if the purpose of the contract is to lead to the actual delivery of the commodity, then the contract is "physical", not "financial". He based his analysis as to the intention of the parties solely on the terms of the written contracts. His reasoning does not recognize that the "financial" purpose of a transaction may be a very important, if not predominant, reason for entering into the transaction, even where the contract calls for physical delivery of the commodity. That transactions which call for physical delivery are essentially financial, is proven by the fact that entities such as Canadian Banks, which are solely in the business of providing financial services in accordance with the *Bank Act*, are active in this market and consider offering these type of contracts simply as offering a financial service to their customers. Physically settled products provide the same benefits, price discovery, price risk management and liquidity, as cash settled forwards and commodity swaps: institutions offer them to their customers indifferently and in order to provide these benefits.

43. "Physical" and "financial" transactions are not mutually exclusive categories, particularly with respect to sales of natural gas, where the market is highly liquid and the distinction between physical and financial contracts does not really exist (except in rare circumstances). Given the liquidity of natural gas markets, purchasers can readily off-load their obligations to take delivery of gas under a physical contract by entering into a contract to make delivery of the same quantity of gas at the same point of delivery. These offsetting arrangements can be made with either the original seller or a new party. By entering into these arrangements, purchasers need never take delivery of gas. In this sense, the market operates like an exchange in that parties agree to make or take delivery, but can and often do settle their obligations by entering into offsetting contracts. Banks and other financial intermediaries often enter into physical gas contracts with no intention of every taking possession of the commodity, even though their agreements are identical in material respects to the agreements that would be entered into between producers and either end-users or gas marketers. The Banks

would be in exactly the same position if the contracts allowed for cash settlement as opposed to physical delivery or as an alternative to physical delivery.

44. If the Learned Judge's comments were interpreted as requiring an investigation as to the subjective intention of the parties in terms of whether or not they intended to make or take delivery, the distinction suggested by the Decision would also be unworkable. Reducing section 11.1 to such a subjective level would be to re-introduce precisely the sort of unpredictability into these sorts of transactions that Parliament was seeking to avoid. In any event, it is not possible in many cases to discern a single subjective intention of the parties. A producer may intend to deliver its gas, but the bank or financial intermediary counterparty will not intend to take physical control of that commodity. A financial intermediary that is also a marketer may have either intention or may change its intention with respect to a particular contract during the life of the contract. Having a common intention in this regard is simply not relevant in this type of market.

45. It is submitted that it is inappropriate to rely on the parties' intentions either as evidenced by the written contracts or based on other subjective evidence as the determinative factor as to whether a contract is of a "financial" or "physical" nature.

The Object of the CCAA

46. One of the concerns raised by the Court below was to construe the term "eligible financial contract" as including contracts which provide for physical delivery would defeat the restructuring objective of the CCAA. It is submitted that this concern is unwarranted generally, and particularly in the circumstances of the case at bar.

47. Where a party who has entered into hedging arrangements becomes insolvent and seeks CCAA protection, no legitimate purpose is served by allowing the debtor to seek to selectively interfere with termination and netting provisions. If a party can forcibly prevent termination, it exposes the solvent counterparty to involuntary and

potentially unlimited risk. The debtor would be entitled to speculate for free on its "out of the money" transactions improving in value while knowing that it will not be able to pay in any event if the market moves in the other direction. Conversely, the debtor might "cherry pick" by allowing the "in the money" transactions to be terminated for a cash payment (to the debtor). Unless one assumes that debtors cannot restructure without the benefit of winning the lottery, it cannot be concluded termination and netting impedes the chances of a successful restructuring. On the other hand, the cost to the derivatives marketplace of such ad hoc interference is borne by all participants – healthy or otherwise.

48. Where contracts for commodities for which there is an active spot market are allowed to be terminated, the debtor suffers no loss. It receives full value for the beneficial contracts and merely crystallizes the losses on the out of the money ones. If the contracts were in-the-money for the debtor (meaning that the spot market price is lower or now predicted to be lower than the contract price), then it will receive a payment from the counterparty that will make up for the lower spot price. If the contracts were out of the money, then it will owe an amount but will be bale to sell the commodity against at the now higher price. Where the contracts are used for hedging, losses ought to offset gains. Production which had been committed to forward contracts can readily be re-sold on the spot market if need be and the over-all liquidity of such markets will be enhanced by the existence of a healthy and unhindered derivatives marketplace.

49. This analysis is well illustrated by the circumstances of the case at bar. The gas master agreement was in fact terminated as of the date of the CCAA stay order. Blue Range Resource Corporation did not contest that termination. It was able to increase its cash flow and, consequently, the sale price of its properties, by allowing the agreement to be terminated and selling its productions free of those arrangements. Enron was left with a claim against Blue Range for the net termination value under the gas master

agreement. Termination of the agreement and the transactions entered into under it did not, accordingly, defeat the object of the CCAA.

Comparative Legislation

50. The wording in the U.S. Bankruptcy Code differs from the wording in both the BIA and the CCAA, in that it is narrower. Under the U.S. Bankruptcy Code, special protection is available to "forward contract merchants", stockbrokers and financial institutions to terminate, net and set-off "forward contracts" when the counterparty to the "forward contract" files a petition in bankruptcy. A "forward contract" is defined as "a contract (other than a commodity contract) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title [the U.S. Bankruptcy Code,] or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or by-product thereof, with a maturity date more than 2 days after the date the contract has been entered into ...".

> Affidavit of Kenneth M. Raisler, sworn March 31, 1999 ("Raisler Affidavit"), Appeal Book, Volume VII, Exhibit B, p. 1056.
> 11 U.S.C. S 101(25)

51. In interpreting section 11.1(1), the respondents seek to limit its application to derivative instruments and in short seek an interpretation of the language in section 11.1(1) which is far narrower than the language in the American legislation. This flies in the face of the fact that the language used in section 11.1(1) is much broader than its American counterpart. Parliament, with the benefit of the precedent of the American legislation, chose to enact the provisions of section 11.1(1) using the broad and inclusive language of section 11.1. By reason of the narrow reading of such inclusive language, section 11.1 has ironically been made much narrower than the American precedent that Parliament was clearly attempting to improve upon.

52. Under the U.S. *Federal Deposit Insurance Act*, (the "FDIA"), as amended by the *Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, entities that qualify as a forward contract merchant, stockbroker, securities clearing agency or a financial institution can enforce close-out netting provisions in a commodity contract if the financial institution counterparty is in an insolvency situation. As a result of the fact that U.S. financial intermediaries are not subject to an insolvency regime with similar restrictions on close-out netting, U.S. financial intermediaries can hedge their own risks easier than their Canadian counterparts because any counterparty a U.S. institution deals with will be able to net against it. Therefore, if the much narrower interpretation of the Decision is allowed to stand, it may well render Canadian financial intermediaries less competitive in the market than their U.S. competitors who provide similar services. This in turn will significantly impair the ability of Canadian producers and marketers to enter into hedging arrangements because Canadian producers and marketers have less access to U.S. banks than to Canadian banks and, therefore, Canadian producers and marketers will generally have less access to these products than entities they compete with in the U.S. If entities such as Enron, and financial institutions such as Canadian banks, cannot rely on having termination and netting rights under their Master Purchase and Sale Agreements that call for physical delivery, then these products may simply not be available. This is an untenable result, which it is submitted this Honourable Court ought not uphold.

> *Federal Deposit Insurance Act*, (the "FDIA"), as amended by the *Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, Pub. L. No. 101-73, 103 Stat. 183 (1989), Tab 6

Impact of the Decision on the Industry

53. The importance of termination and netting rights for financial intermediaries cannot be understated. This is explained by Grottenthaler and Henderson in their text *The Law of Financial Derivatives in Canada* as follows:

The most important features of a derivatives master netting agreement are the provisions which allow a party to terminate all transactions upon an event of default or other termination event, to calculate the value of all transactions as of the termination date and to net the positive and negative values to determine a lump sum termination amount payable by one party to the other (i.e. close-out netting provisions).

...

It is of the utmost importance to parties that the termination and close-out netting provisions are enforceable against the other party. Unlike the case with many commercial transactions, parties are not willing to accept the risk that these provisions may not be fully enforceable in an insolvency situation. There are several reasons for this. First, many entities that participate in the derivatives market are subject to regulatory requirements that they maintain a certain asset level in relation to their liabilities (i.e. adequate capital). For this purpose, it is desirable to account for their derivatives transactions with their various counterparties on a net basis. Generally regulators will permit netting for capital adequacy purposes only if the party obtains a favourable and largely unqualified legal opinion to the effect that termination and close-out netting are effective in insolvency. The Office of the Superintendent of Financial Institutions in its Guideline with respect to Capital Adequacy Requirements for Banks (Guideline A) states that banks that wish to net transactions will need to satisfy OSFI that they have written and reasoned legal opinions that in the event of any legal challenge that relevant courts and authorities would find the exposure to be the net amount under (a) the law of the jurisdictions where the counterparties are chartered and the laws of any jurisdiction applicable to breaches; (b) the law governing the individual transactions and (c) the law governing any contracts or agreements required to effect netting.

Secondly, because the marketplace for derivatives transactions is a highly competitive and global marketplace, entities governed by the laws of a jurisdiction that does not recognize the effectiveness of termination and close-out netting in an insolvency situation are put at a serious competitive disadvantage.

M.E. Grottenthaler, P.J. Henderson, *The Law of Financial Derivatives in Canada*, (Toronto: Carswell, 1999) at 5.1-5.2.1, Tab 3

54. The Decision will have similar implications under other insolvency and reorganization regimes that exempt a so-called "eligible financial contract", which is defined in exactly the same terms, from statutory provisions preventing termination of contracts, such as the BIA (section 65.1(8)), CDIC (section 39.15(7)) and the WURA (section 22.1(2)).

Conclusion

55. The result of the Decision is to throw into doubt whether any transaction that requires or allows for the physical delivery of a commodity is entitled to the termination and netting protections in Canadian insolvency legislation. As a consequence, this will cause an increased risk exposure in the event of counterparty insolvency for parties that deal in any commodity contract that may be settled by physical delivery, whether documented under an ISDA agreement or any other form of master netting agreement. If financial intermediaries that deal in the precious metals, energy and other commodity markets, in the context of physically-settled transactions, cannot rely on the termination and netting rights set out in their master netting agreements, then, these products may simply not be available. Also, the competitive position of CIBC, Scotia and other Canadian banks and other financial intermediaries in this competitive market may be compromised.

56. The importance of enforcing rights of termination and netting in financial and hedging transactions was recognized by Mr. Justice Farley in *Confederation Treasury Services* v. *Hees International Bank Corp. Inc.* where he stated:

> 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 fundamental for the interlocking financial activities of virtually every major financial and many major non-financial corporations in Canada (and have international links) should not be dealt with in such a manner as to seriously affect its efficiency. Not only is this the situation in non-insolvency situations but as well it is in insolvency situations as Anthony C. Gooch and Linda G. Klein, *A*

Review of International U.S. Case Law Affecting Swaps and Related Derivative Products, August 1, 1992 stated at pp. 38 - 39:

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

Confederation Treasury Services v. Hees International Bank Corp. Inc. (1997), 45 C.B.R. (3d) 204 (Ont. Gen. Div.) at 231, Tab 2

57. It is respectfully submitted that this Court should not sacrifice the stability of such an important part of the Canadian financial system on the basis of a flawed analysis of the circumstances of one debtor.

PART IV—NATURE OF RELIEF REQUESTED

58. ISDA respectfully requests that the appeal be allowed insofar as LoVecchio J.'s interpretation of section 11.1(1) of the CCAA is concerned and that this Honourable Court should clearly reject any suggestion that "eligible financial contracts" excludes contracts which provide for physical delivery of commodities.

PART V - AUTHORITIES

See attached Schedule "A".

PART VI – TIME ESTIMATE

59. The estimate of time required for counsel's argument is twenty-five (25) minutes.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

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SEAN F. DUNPHY

SCHEDULE "A"

1. *Canada Deposit Insurance Corporation Act,* R.S.C.1985, c. C-3, as amended.

2. *Confederation Treasury Services* v. *Hees International Bank Corp. Inc.* (1997), 45 C.B.R. (3d) 204 (Ont. Gen. Div.) at 231.

3. M.E. Grottenthaler, P.J. Henderson, *The Law of Financial Derivatives in Canada,* (Toronto: Carswell, 1999) at 5.1-5.2.1.

4. Minutes of Proceedings and Evidence of Standing Committee on Consumer and Corporate Affairs and Government Operations on September 11, 1991, p.12:7 and 12:28.

5. Proceedings of the Standing Senate Committee on Banking, Trade and Commerce, First Meeting on Bill C-5 on November 4, 1996, p.13:77.

6. *Federal Deposit Insurance Act,* as amended by the *Financial Institutions Reform Recovery and Enforcement Act of 1989,* Pub. L. No. 101-73, 103 Stat. 183 (1989),

7. Standing Committee on Consumer and Corporate Affairs and Government Operations First Report on Bill C-22 on October 7, 1991, p. 15:13–15:14.

8. *Winding up and Restructuring Act*, R.S.C.1985, c. W-11, as amended.

C.A. Action No. 99-18410

IN THE COURT OF APPEAL OF ALBERTA

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985. c. C-36, as am.

AND IN THE MATTER OF BLUE RANGE RESOURCE CORPORATION

BETWEEN:

ENRON CAPITAL & TRADE RESOURCES CANADA CORP.

Appellant
(Applicant)

- and -

BLUE RANGE RESOURCE CORPORATION, HUMBLE PETROLEUM MARKETING LTD., PRICEWATERHOUSECOOPERS INC. in its capacity as Monitor, ROYAL BANK OF CANADA, and FIRST NATIONAL BANK OF CHICAGO

Respondents
(Respondents)

- and -

TRANS CANADA ENERGY LTD. and INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

Intervenors

FACTUM OF INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

STIKEMAN, ELLIOTT
Barristers & Solicitors
Suite 5300
Commerce Court West
Toronto, Ontario M5BL 1B9

Sean F. Dunphy
Tel: (416) 869-5662
Fax: (416) 861-0445

Solicitors for the Intervenor, International Swaps and Derivatives Association, Inc.