

**The ABCs of EFCs:  
Eligible Financial Contracts and Energy Company Insolvency Proceedings**  
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**1. Introduction**

Since the 1990s, Canadian insolvency laws have provided special treatment for complex financial instruments such as swaps, forwards and other derivatives referred to in Canadian insolvency legislation as "eligible financial contracts", or "EFCs". Courts have long recognized that various types of energy trading contracts commonly entered into by energy companies to manage commodity price fluctuations and other risks inherent in their businesses may, depending on their terms, be properly characterized as EFCs. These have included financially settled swaps entered into under ISDAs and in certain circumstances, gas purchase and sale agreements, including those entered into under GasEDIs, NAESBs or ISDAs with a Gas Annex.<sup>1</sup>

Canadian insolvency legislation expressly provides that in insolvency proceedings, the insolvent party to an EFC cannot disclaim an EFC like it can many of its other contracts. Further, unlike other types of contracts, the solvent counterparty cannot be stayed from terminating an EFC and, if applicable, calculating early termination damages. Depending on the circumstances, this may provide priority relief to the solvent counterparty through the exercise of set-off or valid credit support rights if permitted under the terms of the EFC.

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<sup>1</sup> See: (i) the International Swaps and Derivates Association 1992 Master Agreement (Multi-Currency Cross Border) and the 2002 Master Agreement (Multi-Currency Cross Border) (collectively, "**ISDAs**"), (ii) the GasEDI Base Contract for Sale and Purchase of Natural Gas published by GasEDI in 2005 ("**GasEDI**"), (iii) NAESB Base Contract for Sale and Purchase of Natural Gas published by the North American Energy Standards Board in 2002 and 2006 ("**NAESB**"), and (iv) the ISDA North American Gas Annex published in 2004.

The special treatment extended to EFCs in insolvency proceedings is intended to both protect the non-defaulting counterparty from the risk of indeterminate exposure to the insolvent counterparty and to reduce systemic risk in financial markets. This special treatment continues to lead to disputes during insolvency proceedings as to whether various forms of energy trading contracts are properly characterized as EFCs. Parties to EFCs also continue to test the limits on what rights and protections Canadian insolvency laws provide solvent counterparties to EFCs.

These issues have been at the forefront of dealings in Canadian energy markets, where physically settled energy trading contracts may require a nuanced analysis of the terms of the contract to determine whether such contract qualifies as an EFC. This paper provides background on the purpose behind the EFC provisions in Canadian insolvency legislation and reviews both historical and recent court decisions surrounding EFCs and energy trading contracts in insolvency proceedings. The objective of this paper is to clarify the scope and limitations of the protections and legal remedies that may be available, or unavailable, to solvent counterparties to an EFC.

## **2. Overview of Canadian Insolvency Legislation and EFCs**

### **a. *Introduction to Restructuring under Canada's Insolvency Statutes***

Canada's insolvency regime is comprised primarily of two statutes, the *Bankruptcy and Insolvency Act* (the "**BIA**")<sup>2</sup> and the *Companies' Creditors Arrangement Act* (the "**CCAA**").<sup>3</sup> The *BIA* provides the legislative framework to address personal and corporate insolvency. In a bankruptcy, a trustee liquidates the bankrupt's assets and distributes the proceeds in a fair and orderly way among the creditors. In addition, the *BIA* provides procedures, known as "proposals",

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<sup>2</sup> *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 [**BIA**].

<sup>3</sup> *Companies' Creditors Arrangement Act*, RSC 1985, c c-36 [**CCAA**].

for insolvent consumers and businesses to avoid bankruptcy by negotiating an agreement with their creditors to reorganize their financial affairs.

The CCAA provides the legislative framework for insolvent companies with more than \$5 million in debt to reorganize under court supervision.<sup>4</sup> The CCAA is a facilitative statute, aimed at allowing financially distressed businesses to devise a plan of compromise or arrangement with their creditors, with the objective of becoming viable in the future. The Supreme Court of Canada has held that reorganization serves the public interest by facilitating the survival of companies supplying goods or services crucial to the health of the economy or saving large numbers of jobs.<sup>5</sup>

In order to facilitate the objectives of a corporate restructuring, Canada's insolvency statutes provide courts and debtor companies with certain tools. One key feature of a formal restructuring proceeding is the stay of proceedings. The stay of proceedings operates to prevent creditors from taking steps to enforce their rights against a debtor company while it attempts to restructure its affairs. The stay provides the debtor company with some "breathing room" during which it will try to come up with a plan of arrangement or compromise that will satisfy its creditors and permit the company to survive. In a CCAA proceeding, a debtor company must apply to the court for a stay of proceedings, which will be in the discretion of the presiding judge.<sup>6</sup> In proposal proceedings under the *BIA*, a debtor company simply files its proposal or a notice of intention to make a proposal with the Office of the Superintendent of Bankruptcy Canada, whereupon there is an immediate, automatic stay of proceedings.<sup>7</sup>

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<sup>4</sup> Government of Canada, "Fresh Start: A Review of Canada's Insolvency Laws", October 21, 2014, online: *Government of Canada* <<https://www.ic.gc.ca/eic/site/cilp-pdci.nsf/eng/cl00882.html>>.

<sup>5</sup> *Century Services Inc v Canada (AG)*, [2010] 3 SCR 379 at para 18 [**Century Services**].

<sup>6</sup> CCAA, *supra* note 3 at s 11.02.

<sup>7</sup> *BIA*, *supra* note 2 at ss 69 and 69.1.

In addition to the stay of proceedings, another important tool in the insolvency toolbox is the ability for a restructuring debtor company, on notice to the other parties to an agreement and the applicable court officer, to disclaim most kinds of agreements to which the company is a party.<sup>8</sup> The rationale behind allowing this is to permit the restructuring company to rid itself of most types of uneconomic or unprofitable contracts, which would otherwise negatively affect a company's ability to restructure. A party to an agreement that suffers a loss in relation to the disclaimer has a provable claim in the proceeding.<sup>9</sup>

Both the *BIA* and the *CCAA* have many other ways to promote their remedial purposes in order to avoid the social and economic costs of liquidating a debtor company's assets. The primary difference between the two statutes is that the *CCAA* offers more flexibility and greater judicial discretion than the rules-based proposal mechanism under the *BIA*. This has made the *CCAA* more responsive to complex reorganizations.<sup>10</sup> Despite the flexibility afforded to debtors and courts under Canada's restructuring statutes, there are limits to what is permitted to facilitate a company's restructuring, in particular when it comes to EFCs.

**b. Introduction to EFCs in Restructuring Proceedings under the BIA and CCAA**

In the 1990s, following legal developments in the United States, the Canadian federal government amended federal insolvency laws to offer special treatment to EFCs in insolvency proceedings. It was expressly provided that in reorganizations, the solvent counterparty could not be stayed from terminating and netting EFCs.<sup>11</sup> In particular, the legislative amendments allowed "certain financial swap and hedging agreements to be terminated where a notice of intention or a

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<sup>8</sup> *BIA*, *supra* note 2 at s 65.11(1); *CCAA*, *supra* note 3 at s 32(1).

<sup>9</sup> *CCAA*, *supra* note 3 at s 32 (7).

<sup>10</sup> *Century Services*, *supra* note 5 at para 14.

<sup>11</sup> Andrew JF Kent *et al*, "Eligible Financial Contracts vs Insolvency: Round II", Annual Review of Insolvency Law 2008, at p 2 [*Kent*].

proposal [had] been filed".<sup>12</sup> The purpose for adding the eligible financial contract provisions was to ensure the "continued competitiveness of Canadian financial markets" as against the U.S. markets, and to protect the derivatives market from some of the uncertainties inherent in insolvency and restructuring.<sup>13</sup> We note that the "safe harbour" provisions in the US Bankruptcy Code provide similar protection to several different types of contracts, and distinguishes between "swap agreements", "forward contracts" and "commodities contracts".<sup>14</sup>

In 2007, once again following the lead of other jurisdictions, Parliament made additional amendments to its insolvency legislation to further enhance the status of EFCs in restructuring proceedings. In particular, Parliament extended the carve out from the insolvency stays so that in addition to being able to terminate and net, a counterparty can also enforce security over financial collateral held as security for its swap exposure.<sup>15</sup> Another key change in the 2007 amendments was that they authorized the replacement of the existing statutory definitions of EFCs contained in the legislation with a new definition fixed by regulation.<sup>16</sup> Finally, along with the amendments to the *BIA* and *CCAA* which codified the process by which an insolvent debtor may disclaim agreements, provisions were added to prevent a debtor from terminating an EFC. The reason for including EFCs in the list of contract types exempted from the disclaimer power was to permit the solvent counterparty to control the timing of termination so that it would be able to effectively re hedge its exposure on derivatives transactions.<sup>17</sup>

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<sup>12</sup> Canada, Standing Committee on Consumer and Corporate Affairs and Government Operations, *First Report on Bill C-22*, October 7, 1991 at 15:13-15:14.

<sup>13</sup> *Blue Range Resources Corp, Re*, 1999 ABQB 1064 at para 20 [**Blue Range QB**].

<sup>14</sup> See *Bankruptcy Code*, 11 USC (1982).

<sup>15</sup> Pursuant to s 34(8) of the *CCAA* and ss 65.1(9) and 66.34(8) of the *BIA*.

<sup>16</sup> *Kent*, *supra* note 11 at p 2.

<sup>17</sup> Insolvency Institute of Canada, "Report of the Task Force on Derivatives" (26 September 2013), online: <[https://www.insolvency.ca/en/iicresources/resources/IIC\\_Derivatives\\_Task\\_Force\\_Report\\_November\\_2013.pdf](https://www.insolvency.ca/en/iicresources/resources/IIC_Derivatives_Task_Force_Report_November_2013.pdf)> at p 7.

Today, the *BIA* and *CCAA* define "eligible financial contract" as "an agreement of a prescribed kind".<sup>18</sup> The more expansive definition of an EFC was removed from the *BIA* and *CCAA* and put into their respective regulations in order to assist with amending the definition as new financial products develop. The current regulations of the *BIA* and *CCAA* provide a list of certain types of agreements that are considered to be EFCs, which includes a "derivatives agreement" that trades on futures or options exchanges, or is the subject of recurrent dealings in the derivatives markets or in the over-the-counter securities or commodities markets.<sup>19</sup> Importantly for the classification of energy trading contracts as EFCs, a "derivatives agreement" includes "a financial agreement whose obligations are derived from, referenced to, or based on, one or more underlying reference items such as...commodities..." which may include swaps, futures, options, spot or forward contracts.<sup>20</sup>

The special treatment given to EFCs in restructuring and other insolvency proceedings has given rise to litigation over the issue of what may constitute an EFC. This issue has been particularly controversial with respect to contracts dealing with the trade or exchange of a commodity.<sup>21</sup>

### **3. Judicial Interpretation of EFC Provisions and Gas Supply Contracts**

Energy trading contracts, and specifically gas supply contracts, have long been in the grey area as to whether they should be properly characterized as EFCs or not. As discussed below,

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<sup>18</sup> *BIA*, *supra* note 2 at s 2; *CCAA*, *supra* note 3 at s 2.

<sup>19</sup> *Eligible Financial Contract General Rules*, SOR/2007-256 at s 2(a); *Eligible Financial Contract Regulations*, SOR/2007-257 at s 2(a).

<sup>20</sup> *Ibid* at s 1.

<sup>21</sup> *Kent*, *supra* note 11 at p 1.

depending on the nature of the agreement, these types of contracts could, and in fact have been found by courts to fall on either side of that line.

Canadian courts have struggled with the distinction between those commodity contracts that constitute eligible financial contracts and those that might simply be a long-term commercial commodity supply contract. Courts are cognizant of the fact that if the definition of eligible financial contracts were to be construed too broadly, the exemption from the stay of proceedings could inappropriately impair the ability of insolvent debtors to restructure. On the other hand, counterparties to fixed price commodity contracts or fixed-floating swaps have a different risk profile than other creditors *vis-à-vis* the insolvent counterparty in that, during the insolvency proceedings, their mark to market exposure will continue to fluctuate on account of ongoing price changes in the underlying commodity. Allowing a solvent party to terminate and close out its position will at least fix the value of such exposure and prevent it from being exposed to uncertain and unmanageable risk. It will also prevent the insolvent counterparty from being granted an effective option over that exposure during the stay of proceedings by having a right to disclaim if the price moved against it or electing to keep the contract in place if the price moved in its favour. A court will need to consider the contract in question as a whole to determine whether a particular commodity supply contract truly serves an underlying "financial purpose" or whether it is predominantly a supply of offtake agreement.

**a. *Blue Range***

The first case which considered whether gas supply agreements could be properly characterized as EFCs involved Blue Range Resources Corp. ("**Blue Range Corp.**"), which was a producer of natural gas that entered into a number of long-term natural gas supply agreements

with various gas marketing companies.<sup>22</sup> In March 1999, Blue Range Corp. was granted an initial order staying proceedings against it pursuant to section 11 of the CCAA.<sup>23</sup> The initial order permitted the termination of certain agreements and restrained the exercise of certain rights, including set-off rights, without the consent of Blue Range Corp. The initial order did not prohibit parties to eligible financial contracts from terminating or setting off with Blue Range Corp.<sup>24</sup> Enron Gas Services Corp. sought a declaration that its gas purchase and sale contracts with Blue Range Corp. were EFCs within the meaning of the CCAA.<sup>25</sup>

The Chambers Court considered the purpose of the CCAA in assisting insolvent companies and their solvent counterparties through insolvency.<sup>26</sup> The Chambers Court then looked at the definition of eligible financial contract, and the distinction between "physical" and "financial" contracts<sup>27</sup> and noted that eligible financial contracts are the exception and not the rule in the CCAA, such that the Chambers Court was reluctant to expand on what is within the ambit of the term.<sup>28</sup> After assessing the contracts in question, the Chambers Court found that although the contracts resembled financial swap transactions in that they were intended to be part of the creditors' overall risk management portfolio, their primary uses were physical in nature, as opposed to financial.<sup>29</sup> The Chambers Court went on to state that if it were to hold that the contracts were EFCs, it would defeat the object of the CCAA stay of proceedings, because the intent was only to protect future, forward or other commodity contracts which were financial in

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<sup>22</sup> *Blue Range QB*, *supra* note 13 at para 3.

<sup>23</sup> *Ibid* at para 4.

<sup>24</sup> *Ibid* at para 4.

<sup>25</sup> *Ibid* at para 1.

<sup>26</sup> *Ibid* at paras 8-9.

<sup>27</sup> *Ibid* at paras 10-34.

<sup>28</sup> *Ibid* at para 53.

<sup>29</sup> *Ibid* at para 54.



nature. The Chambers Court concluded that since these contracts were not financial in nature, they could not be EFCs within the meaning of the CCAA.<sup>30</sup>

The Court of Appeal of Alberta overturned the finding of the Chambers Court and ruled the contracts in question were EFCs. In doing so, the Appeal Court determined that in order to qualify as an eligible financial contract, the agreements in question had to fit within the definition in the CCAA, which included "a spot, future, forward or other commodity contract". The Court explained the utility of the gas hedging and derivatives market and determined that although the contracts did contemplate eventual physical settlement by the delivery of natural gas, they served an important financial purpose as risk management tools. The Court considered the importance of enforceable termination and netting out provisions in contracts to avoid insolvent companies' ability to selectively repudiate contracts, known as "cherry picking", which can lead the non-defaulting party to excessive and unmanageable risk.<sup>31</sup> The Court in *Blue Range* granted the appeal and held that natural gas is a commodity, and physically settled forward commodity contracts were included in the CCAA's definition of eligible financial contracts.<sup>32</sup> Notwithstanding, the Court found that it was necessary to limit this classification to contracts for fungible commodities that trade in a liquid and volatile market, such as natural gas.<sup>33</sup> This result satisfied the final test of fairness to the parties, because unlike with specialty goods, gas producers whose contracts have been terminated can readily sell their gas in the spot market, and solvent counterparties get the opportunity to crystallize their losses and move on.<sup>34</sup>

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<sup>30</sup> *Ibid* at para 56.

<sup>31</sup> *Re Blue Range Resource Corp, Re*, 2000 ABCA 239 at paras 17-31 [*Blue Range*].

<sup>32</sup> *Ibid* at paras 39-46.

<sup>33</sup> *Ibid* at paras 42-45, 54.

<sup>34</sup> *Ibid* at paras 52-53.

**b. Androscoggin**

Androscoggin Energy LLC ("**Androscoggin Energy**") operated a cogeneration plant in Maine, U.S.A. In November 2004, Androscoggin Energy filed for bankruptcy under Chapter 11 of the United States Bankruptcy Code with the United States Bankruptcy Court, District of Maine, and on the same day obtained recognition of the U.S. proceeding as a "foreign proceeding" under the CCAA.<sup>35</sup> The recognition order stayed all actions against Androscoggin Energy in Canada and specifically the rights to terminate certain gas supply contracts or to enforce other contractual rights.<sup>36</sup> Several companies sought a declaration from the Chambers Court that the long-term gas supply contracts they had with Androscoggin Energy were EFCs under the CCAA and that the stay of proceedings did not apply to the contracts in question.<sup>37</sup>

The Chambers Court noted that the intent of Parliament in enacting the EFC provisions in insolvency legislation was to protect transactions that were financial in nature. The Chambers Court found that the essential relationship between Androscoggin Energy and the companies was the physical delivery of gas.<sup>38</sup> The Chambers Court therefore concluded that the contracts were not EFCs. The Court went on to comment that even if the contracts were found to be EFCs and exempt from a stay imposed by the CCAA, that would not have allowed the companies to terminate the contracts, since the terms of the contracts stipulated that they could only be terminated if Androscoggin Energy failed to arrange for payment.<sup>39</sup> In other words, the terms of the EFCs were just as important as the classification as such, and the legislative provisions only permit enforcement of rights specifically provided for in the contract. Despite having a fixed price,

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<sup>35</sup> *Re Androscoggin LLC*, [2005] OJ No 592, 137 ACWS (3d) 246 (ONCA) at para 2 [**Androscoggin**].

<sup>36</sup> *Ibid* at para 2.

<sup>37</sup> *Androscoggin Energy LLC, Re*, [2005] OJ No 395, 136 ACWS (3d) 993 (ONSC Commercial List) at para 1 [**Androscoggin Chambers**].

<sup>38</sup> *Ibid* at paras 3-7.

<sup>39</sup> *Ibid* at para 12.

the Court found that these contracts carried none of the "hallmarks" of an EFC, and therefore could not be characterized as such.<sup>40</sup>

On appeal by the producers, the Court of Appeal of Ontario unanimously affirmed the Chambers Court decision. In doing so, the Court noted that unlike the contracts in *Blue Range*, which enabled the parties to: (i) manage the risk of a commodity's price by allowing the counterparty to terminate the agreement in the event of insolvency proceedings, (ii) offset or net obligations owing under the contracts to determine the value of commodity yet to be delivered, and (iii) re hedge in positions, the contracts in this case did not allow for any of these risk management methods.<sup>41</sup> Therefore, the Court held the contracts were not EFCs regardless of what *pro forma* insertions of terms were made to the contracts. The Court found that regard must be had to the contract as a whole to determine its character.<sup>42</sup>

### c. *Calpine*

Pursuant to an agreement, Calpine Canada Natural Gas Partnership ("**Calpine**") sold certain oil and natural gas rights and assets located on lands in British Columbia to Pengrowth Corporation ("**Pengrowth**"). As part of the transaction, the parties entered into a Call on Production Agreement (the "**COP Agreement**"), which provided Calpine with a reoccurring right of first refusal to purchase any portion of the gas or oil produced from the lands that were sold on market terms and conditions.<sup>43</sup>

In December 2005, the Calpine group sought, and was granted, an initial order under the CCAA. The initial order restrained persons from terminating or suspending their obligations under

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<sup>40</sup> *Androscoggin*, *supra* note 35 at para 15.

<sup>41</sup> *Ibid* at para 15; see also *Blue Range*, *supra* note 31.

<sup>42</sup> *Ibid* at para 15.

<sup>43</sup> *Re Calpine Canada Energy Ltd*, 2006 ABQB 153 at paras 3-4 [**Calpine**].

agreements with the applicants during the term of the order, as long as the applicants paid the normal prices for the goods and services provided under such agreements.<sup>44</sup> Pengrowth provided notice to Calpine that it would suspend delivery of natural gas to it under the COP Agreement. In addition, Pengrowth alleged that the COP Agreement was an eligible financial contract, and thus exempt from the application of the stay set out in the initial order.

After reviewing and considering the decisions in *Blue Range* and *Androscoggin*, the Chambers Court determined that the COP Agreement, as a whole, lacked the characteristics or hallmarks of an EFC.<sup>45</sup> In particular, the Chambers Court found the COP Agreement did not meet the fixed price requirement, but instead relied upon market pricing.<sup>46</sup> In addition, the Court found the term of the contract was uncertain and that the volume of gas to be produced and purchased under the COP Agreement could not be defined. Moreover, Pengrowth was not obliged to produce at any specific rate and there were no offsetting or netting provisions.<sup>47</sup> In summary, the Chambers Court found the COP Agreement could not be "marked to market", which is contrary to the characteristic identified in *Blue Range*, that "(f)orward gas contracts ... have a calculable cash equivalent".<sup>48</sup>

The Chambers Court in *Calpine* concluded that the price of gas under the COP Agreement was not a predetermined, fixed price that in the normal course could prudently be hedged by an offsetting contract.<sup>49</sup> The COP Agreement in its essential terms was found to be analogous to the

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<sup>44</sup> *Ibid* at para 6.

<sup>45</sup> *Ibid* at para 18.

<sup>46</sup> *Ibid* at para 18.

<sup>47</sup> *Ibid* at paras 18-19.

<sup>48</sup> *Ibid* at para 19.

<sup>49</sup> *Ibid* at para 20.

type of contract specifically exempted from the category of an EFC, namely a standard gas utility contract.<sup>50</sup>

**d. Bellatrix**

The recent decision of the Court of Queen's Bench of Alberta in *Bellatrix*<sup>51</sup> is the first decision to consider the requirements for gas supply contracts to qualify as an EFC since the 2007 amendments were made to the definition of eligible financial contract in the *BIA* and *CCAA*.

Bellatrix Exploration Ltd. ("**Bellatrix**") and BP Canada Energy Group ULC ("**BP Canada**") were parties to certain contracts for the purchase and sale of natural gas (the "**GasEDI Agreement**").<sup>52</sup> Pursuant to the terms of the GasEDI Agreement, Bellatrix was required to supply certain volumes of gas per day to BP Canada at a price equal to the average of three gas spot prices,<sup>53</sup> reduced by a fixed transportation fee.<sup>54</sup> Since the time Bellatrix entered into the GasEDI Agreement, the differentials between the AECO spot price and the downstream market spot prices had narrowed and the transportation fees embedded in the contract became uneconomical.

In October 2019, the Court of Queen's Bench of Alberta granted Bellatrix protection under the *CCAA*.<sup>55</sup> While under *CCAA* protection, Bellatrix purported to disclaim the GasEDI Agreement and ceased delivery of natural gas under the contract with the monitor's approval.<sup>56</sup> In January 2020, BP Canada filed an application in the *CCAA* proceeding seeking an order, among other things, declaring the GasEDI Agreement was an EFC within the meaning of the *CCAA*.

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<sup>50</sup> *Ibid* at para 22.

<sup>51</sup> *Re Bellatrix Exploration Ltd*, [2020] AJ No 329, [2020] AWLD 1317 [**Bellatrix**].

<sup>52</sup> *Ibid* at para 3.

<sup>53</sup> California (Malin), Midwest Chicago Citygate and Dawn, Ontario.

<sup>54</sup> *Bellatrix*, *supra* note 51 at para 63.

<sup>55</sup> *Ibid* at para 2.

<sup>56</sup> *Ibid* at paras 4-5.

The Chambers Court noted that despite the contract not specifying a fixed price for BP Canada's purchase of the natural gas, the GasEDI Agreement provided a mechanism by which an amount could be determined to be owing by a defaulting party, which would be payable in a prescribed amount of time, and the contract allowed for prompt set-off and netting.<sup>57</sup>

Following *Blue Range*, the Chambers Court found that agreements for physical delivery of commodities could be EFCs. Specifically, the fact that the purpose of the GasEDI Agreement was for the delivery of gas did not bar it from being an EFC if the GasEDI Agreement served a financial purpose.<sup>58</sup> The Chambers Court noted that although the GasEDI Agreement was not a hedging contract, it was part of Bellatrix's hedging program and overall risk management strategy to achieve price diversification.<sup>59</sup> Accordingly, the Court concluded the contract served an important financial purpose and was a financial agreement for the purposes of the definition of an EFC under the CCAA. In considering the scheme of the CCAA and the definition of eligible financial contracts as a whole, the Chambers Court concluded that the definition of an EFC does not require that a gas supply agreement contain a fixed price. A pricing mechanism capable of being determined at a later date is sufficient.<sup>60</sup>

In concluding that the GasEDI Agreement was an EFC, the Chambers Court summarized several important points that energy companies should be aware of: (i) physically settled contracts are not disqualified from being eligible financial contracts; (ii) a fixed price is not required for a gas supply contract to be considered an EFC; and (iii) although the case was unique in that the solvent

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<sup>57</sup> *Ibid* at paras 50-51.

<sup>58</sup> *Ibid* at paras 123-125.

<sup>59</sup> *Ibid* at paras 127-139.

<sup>60</sup> *Ibid* at paras 94-97.

counterparty did not wish to terminate and exercise set-off rights, that should not affect the characterization of the contract as being an EFC.<sup>61</sup>

Leave to appeal *Bellatrix* was allowed in May 2020,<sup>62</sup> and the appeal was heard by the Court of Appeal of Alberta in October 2020. In late April 2021, the Court of Appeal dismissed Bellatrix's appeal on the basis that the issue had become moot as a result of a subsequent decision of the Chambers Court (discussed below) finding that Bellatrix's first lien lenders had priority to the proceeds of sale of Bellatrix's assets, among other funds, over the claim of BP Canada in the CCAA proceeding.<sup>63</sup>

#### **4. Energy Contracts as EFCs**

There is a myriad of forms of energy trading contracts which marketers, energy producers and end-users of energy products, such as electrical generators and petro-chemical and fertilizer producers, enter into for a variety of reasons. Some contracts may be simple supply and offtake arrangements used to ensure they can buy or sell key inputs or products associated with their normal business operations. Others can be highly complex financial instruments used to manage financial risks in their businesses, including on account of the fluctuations and uncertainties inherent in the prices of oil, natural gas, electricity and other commodities. These price fluctuations can have a dramatic impact on a company's bottom line in any given year.

As the cases above illustrate, some but not all of these types of arrangements may be properly characterized as EFCs in the event of an insolvent contractual counterparty. Each of the GasEDI Base Contract and the Canadian Addendum to the NAESB Base Contract under which a majority of the over-the-counter physically-settled gas transactions are conducted in Canada,

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<sup>61</sup> *Ibid* at paras 206-212.

<sup>62</sup> See *Bellatrix Exploration Ltd, Re*, 2020 ABCA 178.

<sup>63</sup> See *Bellatrix Exploration Ltd v BP Canada Energy Group ULC*, 2021 ABCA 148.

contain provisions stating the contracts are intended to constitute EFCs.<sup>64</sup> However, while a Court may consider the existence of such *pro forma* provisions to give effect to parties' intentions at the time the contracts are entered into, the existence of such provisions is not determinative. Accordingly, parties should consider whether the essence of any contract is set up to serve an underlying financial purpose.

A contract which is set up to hedge commodity price exposure will more likely be found to serve a financial purpose compared to a simpler physical supply contract with delivery at a liquid delivery point which is settled at the index price associated with such delivery point. Two common ways to hedge commodity price exposure are to either enter into a long-term physical supply or off-take agreement with a fixed or fixed-variable price, or to enter into variable or index priced supply and off-take agreements coupled with financially-settled fixed-floating swaps. Out of these types of agreements, fixed-price contracts and financially settled swaps will typically share more characteristics, or "hallmarks" of an EFC. Whereas a pure variable indexed price supply or off-take agreement may not. That said, in *Bellatrix* the Chambers Court found that a contract that sought to achieve "price diversity" utilizing a basket of index prices was enough to satisfy the financial purpose test, and in *Androscoggin*, a contract that had a fixed price element was determined not to be an EFC.

## **5. Remedies for Solvent Counterparties to EFCs**

### **a. *The Statutory Protections for EFCs are Limited***

As discussed above, the *BIA* and *CCAA* provide certain special protections for EFCs. These protections however do not grant any security or priority for contractual damages claims to counterparties to an EFC. Rather, the purpose of the protections for EFCs is to provide stability

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<sup>64</sup> See s 10.5 of the 2006 NAESB as modified by the NAESB 2007 Canadian Addendum and s 14.11 of the GasEDI.



of financial markets by allowing for the right of a non-defaulting counterparty to terminate and crystallize claims arising under an EFC.

The general stay of proceedings prevents, among other things, contractual counterparties from terminating an agreement because of a contractual counterparty's insolvency. The *BIA* and *CCAA* exempt non-insolvent counterparties of EFCs from the stay in this respect.<sup>65</sup> Solvent counterparties to an EFC have limited "[p]ermitted actions" during the stay period, as follows:

The following actions are permitted in respect of an eligible financial contract that is entered into before proceedings under this Act are commenced in respect of the company and is terminated on or after that day, but only in accordance with the provisions of that contract:

- (a) the netting or setting off or compensation of obligations between the company and the other parties to the eligible financial contract; and
- (b) the dealing in any financial collateral.<sup>66</sup>

Although these provisions allow for the setting off and netting of obligations after the termination of an EFC, the *BIA* and *CCAA* do not permit enforcement actions to recover net termination values once they are determined.<sup>67</sup> Rather, the statutes deem the non-insolvent counterparty "to be a creditor of the company with a claim against the company in respect of those net termination values".<sup>68</sup> As a deemed creditor of the company, the non-insolvent counterparty is like other creditor, subject to the stay of proceedings. This is consistent with the recommendation made by the Canadian Bankers' Association when it lobbied for EFC amendments to the *BIA* in 1991:

...it cannot be overemphasized that our proposal is not to benefit either party to an eligible financial contract. ... Any net amount, if owed to the other party, would be fully subject to the proposed stay provisions. What would be achieved is that the rights of both parties would have been

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<sup>65</sup> *BIA*, *supra* note 2 at 66.34(7); *CCAA*, *supra* note 3 at s 34(7).

<sup>66</sup> *CCAA*, *supra* note 3 at s 34(8); see also *BIA*, *supra* note 2 at ss 65.1(9) and 66.34(8).

<sup>67</sup> *CCAA*, *supra* note 3 at s 34(10); *BIA*, *supra* note 2 at ss 65.1(10) and 66.34(9).

<sup>68</sup> *CCAA*, *supra* note 3 at s 34(10); see also *BIA*, *supra* note 2 at ss 65.1(10) and 66.34.

reduced to a fixed and certain amount, just like an amount owed under a regular contract at the time of the stay. [Emphasis added.]<sup>69</sup>

Unless the non-insolvent counterparty to the EFC has a security interest in relation to any applicable net termination value, it will be an unsecured creditor in respect of such amounts. The Court of Appeal of Alberta in *Blue Range* noted that a non-defaulting unsecured creditor to an EFC is treated like any other unsecured creditor in a CCAA proceeding and ultimately receives whatever pro-rated payment other unsecured creditors receive.<sup>70</sup>

Following the decision in *Bellatrix*, a priority dispute arose between the first lien lenders and BP Canada to certain sale proceeds from Bellatrix's estate.<sup>71</sup> After the Chambers Court determined the GasEDI Agreement was an EFC which could not be disclaimed, instead of terminating the GasEDI Agreement and exercising set-off rights, BP Canada demanded that Bellatrix resume performance, which Bellatrix did not do. Following the sale of most of Bellatrix's assets, Bellatrix's first lien lenders asserted priority to the proceeds of sale and certain amounts held in trust on account of BP Canada's last payment under the GasEDI Agreement.<sup>72</sup> BP Canada sought a return of its payment and distribution of the sale proceeds to cover amounts owing on account of its damages claim for Bellatrix's post-CCAA filing breach of contract, in priority to secured creditors.<sup>73</sup>

The Chambers Court found that the protection offered to solvent counterparties to an EFC is the ability to terminate the EFC and crystallize its loss despite the stay, a protection not afforded to other creditors.<sup>74</sup> The other protection is allowing set-off if the EFC agreement itself permits.

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<sup>69</sup> *Androscoggin*, *supra* note 35 at para 3.

<sup>70</sup> *Blue Range*, *supra* note 31 at para 9.

<sup>71</sup> *Re Bellatrix*, 2020 ABQB 809 [***Bellatrix 2***].

<sup>72</sup> *Ibid* at para 29.

<sup>73</sup> *Ibid* at para 30.

<sup>74</sup> *Ibid* at para 38

The Chambers Court found the protections for EFCs did not require the insolvent party to perform an EFC that has not been terminated, nor do the provisions provide the solvent counterparty with any priority for its claim.<sup>75</sup> The first lien lenders' application was therefore granted, declaring them to have priority to the sales proceeds and the funds held in trust.<sup>76</sup>

Given the decision in *Bellatrix 2*, it is clear that solvent counterparties cannot rely upon the disclaimer exception for EFCs under the insolvency statutes to demand continued performance of an EFC. Instead, solvent counterparties to an EFC may elect to terminate an EFC to assert any netting or set-off rights they may have, or potentially enforce on any validly held credit support or other security previously provided by the insolvent counterparty.

**b. *The Protections for EFCs are Limited by the Terms of the Contract***

While the characterization of an energy trading contract as an EFC provides the non-insolvent counterparty with certain rights, the practical implications in the enforcement of such rights will be subject to the terms of the EFC. As noted by the Chambers Court in *Androscoggin*, the terms of an eligible financial contract are equally important as the characterization of a contract as an EFC.<sup>77</sup> In other words, simply having an EFC will not provide sufficient protection to terminate, net and set-off if the contract does not provide for such remedies upon a counterparty insolvency. Likewise, the ability to deal with financial collateral is not helpful if no security or valid credit support is provided in connection with the EFC.

Parties should consider what will be required to ensure adequate protection in the event of a contractual counterparty's insolvency. As illustrated by the commentary in *Androscoggin*, this

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<sup>75</sup> *Ibid* at para 38.

<sup>76</sup> Leave to appeal the decision in *Bellatrix 2* was denied by the Court of Appeal of Alberta. See *Re Bellatrix Exploration Ltd*, 2021 ABCA 85.

<sup>77</sup> *Androscoggin*, *supra* note 35 at para 12.

would include having rights to terminate and potentially to calculate liquidated damages upon such insolvency clearly set out in the contract. It may also mean ensuring there are risk management protections in place, including structuring the arrangement so there is adequate credit support or offsetting contracts to provide coverage through the exercise of set-off rights. It is also important to ensure there are clear rights under the EFC to set-off and net obligations after the termination of an EFC. Courts have been clear that such rights are only available if specifically provided for in the EFC, unless a party wants to try and pursue legal or equitable set-off, which may still be available but with less certainty.<sup>78</sup>

If a non-insolvent party exercises its rights to terminate and close out an EFC with the calculation of early termination damages and the solvent party holds valid credit support or security to backstop those obligations, it may exercise its rights to cover all or a portion of the early termination damages.<sup>79</sup> Similarly, if the solvent party owes the insolvent party amounts under any other agreements where set-off is available it may exercise set-off rights.

Lastly, *Bellatrix 2* provides a good example as to why it is important for the non-insolvent counterparty to exercise its rights of termination under the EFC sooner rather than later. As noted above, the *BIA* and *CCAA* permit the netting or setting off of obligations between the debtor company and the other party to the EFC if the EFC is terminated on or after the commencement of the insolvency proceedings.<sup>80</sup> In *Bellatrix 2*, BP Canada had not terminated the GasEDI Agreement and was not seeking to terminate and set-off its position to reduce exposure to risk.

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<sup>78</sup> See *Bellatrix 2*, *supra* note 71 at paras 49-63 for discussion on set-off.

<sup>79</sup> Pursuant to s 34(8) of the *CCAA* and ss 65.1(9) and 66.34(8) of the *BIA*.

<sup>80</sup> *Bellatrix 2*, *supra* note 71 at para 49.

The Chambers Court therefore held that the set-off provision for EFCs under the CCAA was not available to it.<sup>81</sup> Leave to appeal the Chambers Court's ruling was denied.<sup>82</sup>

### **c. Credit Support and Performance Assurances**

When entering into complex energy trading arrangements, the credit support and performance assurance provisions are often amongst the most heavily negotiated. This is because of the large exposure that may arise on account of fluctuating commodity prices over the term of the contracts, which can lead to large "in the money" or "out of the money" positions. Having valid and enforceable credit support, that is not subject to priority claims of other creditors, is often the best and most practical way to mitigate losses in the event of a counterparty's insolvency, where the solvent party holds the "in the money" position. In negotiations regarding credit support obligations, the parties must have both regard to the events or tests which trigger an obligation to post credit support and the form and quantum that acceptable credit support may take.

The most common and preferred forms of credit support in these arrangements in Canada include a letter of credit, a performance bond or a guarantee, in each case provided by an acceptable creditworthy entity. Alternatively, a prepayment or a security interest in an asset may be acceptable. Cash, which is commonly used as credit support for these types of agreements in the U.S., is a less desirable form of credit support in Canada given you cannot perfect a security interest in cash pursuant to the *Personal Property Security Act* (Alberta) and comparable legislation in a number of other Canadian jurisdictions by possession if it is simply placed in an account controlled by the secured party. If held in the secured party's account, the collateral will

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<sup>81</sup> *Ibid* at para 50.

<sup>82</sup> See *Re Bellatrix Exploration Ltd*, 2021 ABCA 85.

be subject to any priority claims there may be from other secured creditors with perfected security registrations in that collateral.<sup>83</sup>

If a contract is found to be an EFC and the non-insolvent party has valid credit support, that party will be entitled to either: (i) terminate and close out on the contract and enforce against such credit support with respect to any early termination damages, or (ii) prevent the insolvent counterparty from disclaiming the contract and exercise against such credit support to cover any damages which arise.

## **6. Set-off**

Set-off is another powerful tool which, if available, may be utilized post-insolvency. This may be by allowing the non-defaulting party to subtract any amounts it owes to the insolvent party from amounts the insolvent party owes it. Set-off rights will of course only be available in the event there are actually amounts owing in both directions as between the applicable parties. It is often the case amongst larger corporations and financial institutions for such relationships to exist. These rights may be important in the context of an EFC where a solvent party is entitled to calculate early termination damages when terminating and closing out the contract which amounts may then, in certain circumstances, be set-off against other amounts owed to the insolvent counterparty.

Each of the *BIA* and the *CCAA* expressly permit set-off during insolvency situations.<sup>84</sup> This right is also extended to holders of EFCs.<sup>85</sup> However, while courts will often allow for enforcement of a set-off arrangement in an insolvency, they will first be careful to ensure it is a properly

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<sup>83</sup> See the *Personal Property Security Act, RSA 2000, c P-7* at ss 1(b), (x) and (cc), 19, 20 and 24; see also Uniform Commercial Code, § 9-104 and 9-314 (2012) for American equivalent.

<sup>84</sup> *BIA, supra* note 2 at s 97(3); *CCAA, supra* note 3 at s 21.

<sup>85</sup> *BIA, supra* note 2 at ss 65.1(9) and 66.34(8); *CCAA, supra* note 3 at s 34(8).

constructed arrangement, as set-off essentially works to provide a super priority over other creditors in an insolvency proceeding with respect to the amounts set-off. It should be noted that notwithstanding the preservation of set-off rights in the *BIA* and the *CCAA*, a Court may, in certain circumstances, nonetheless stay the exercise of set-off rights as a debtor works through a complex restructuring.<sup>86</sup>

As seen in *Bellatrix 2*, in exercising set-off rights in respect of an EFC, it is important to terminate the contract prior to enforcing any set-off rights there may be under an EFC. In non-EFC related cases, there is conflicting case law as to whether parties will be entitled to set-off pre-filing claims against amounts that become owing post-filing. For instance, set-off rights between pre-filing and post-filing obligations were allowed in *Air Canada*<sup>87</sup> (subject to a "temporal stay"), but were not allowed in *Kitco*.<sup>88</sup> or *SMI*.<sup>89</sup> The case law regarding pre-filing and post-filing set-off in non-EFC cases is complicated and beyond the scope of this paper.

In Canada, as it relates to energy trading contracts, there are three primary forms of set-off recognized by the courts: (i) contractual set-off, which consists of set-off rights expressly set out in a contract; (ii) legal (common law) set-off, which requires mutuality of obligations and the applicable debts between the parties to be on a liquidated basis (i.e. they can be calculated with certainty); and (iii) equitable set-off, which is a discretionary remedy granted by the courts if it determines that it would be un-equitable to not allow set-off in the circumstances.<sup>90</sup>

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<sup>86</sup> *North American Tungsten Corp, Re*, 2015 BCSC 1382, leave to appeal denied in *North American Tungsten Corp v Global Tungsten and Powders Corp*, 2015 BCCA 390.

<sup>87</sup> *Re Air Canada*, [2003] OJ No 06058, 39 BLR (3d) 153 [*Air Canada*].

<sup>88</sup> *Arrangement relatif a Metaux Kitco inc*, 2017 QCCA 268 [*Kitco*].

<sup>89</sup> *Arrangements relatifs a Groupe SMI inc*, 2018 QCCS 5319 [*SMI*].

<sup>90</sup> Lloyd W Houlden, Geoffry B Morawetz & Dr Janis P Sarra, *Bankruptcy and Insolvency Law of Canada, 4th ed* (Toronto: Thomson Reuters Canada, 2009, loose-leaf updated 2021), Set-Off at F§237 (Part IV s 97), online: WestlawNext Canada; see also *Telford v Holt*, [1987] 2 SCR 193, 41 DLR (4<sup>th</sup>) 385 for discussion on set-off.

To ensure enforceability of a contractual set-off arrangement in an insolvency, the parties should ensure that it also complies with common law or equitable doctrines of set-off. Further, given that equitable set-off is a *post-facto* discretionary remedy of the Court, which cannot be predicted with the requisite degree of certainty, if relying on set-off rights as a risk management tool, the parties should ensure the arrangement satisfies the requirements for legal set-off.

A common area for issues to arise around enforcement of set-off rights in an insolvency scenario is where, rather than being limited to "bilateral" set-off between the actual parties to a contract, a contract permits "triangular" set-off rights. Triangular set-off purports to allow set-off as between the parties and certain third parties, most often being affiliates of the contracting parties. Such arrangements have been found to be unenforceable in various insolvency proceedings including in *SemCanada*,<sup>91</sup> which was an Alberta case that found such rights to be unenforceable on account of privity of contract. Further, the Court in *SemCanada* found that while a party may contract for the benefit of an affiliate, it cannot bind its affiliate without that affiliate's consent.<sup>92</sup> In the U.S., a number of insolvency decisions have found that such triangular arrangements did not satisfy the test of legal set-off because there was no mutuality of obligations.<sup>93</sup>

If parties wish to strengthen the potential for triangular set-off rights to be enforceable in the event of insolvency, it is prudent to draw a contractual nexus as between all applicable affiliates in a manner that provides for mutuality of obligations such that it satisfies the test for legal set-off.

## 7. Conclusion

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<sup>91</sup> *Re SemCanada Crude Co*, 2009 ABQB 715 [**SemCanada**].

<sup>92</sup> *Ibid* at para 17.

<sup>93</sup> See *In re Lehman Brothers Inc*, 458 BR 134 (Bankr SDNY 2011); see also *In re Orexigen Therapeutics, Inc*, 596 BR 9 (Bankr D Del 2018).



Canadian courts continue to struggle with determining which energy trading contracts are properly characterized as EFCs in insolvency proceedings. The jurisprudence provides that physically settled contracts can be EFCs and a fixed price is not necessarily required for a gas supply contract to be considered an EFC. Courts will look to determine whether the essence of any contract is to serve an underlying financial purpose. A contract that is set up to hedge commodity price exposure will more likely be found to serve such a financial purpose as compared to a simpler physical supply contract which is settled at the index price associated with a liquid delivery point.

Parties to energy trading contracts must also be aware that while the characterization of an energy trading contract as an EFC provides the non-insolvent counterparty with certain rights, the practical implications in the enforcement of such rights will be subject to the terms of the EFC. Accordingly, parties must be careful to include sufficient protections in the event of a contractual counterparty's insolvency including termination, netting and set-off rights upon such insolvency, as well as an ability to enforce against any financial collateral provided in connection with the EFC.

Finally, parties to energy trading contracts that are EFCs should be aware of the limits to the special treatment for EFCs under Canada's insolvency statutes. If provided for in the contract, a solvent counterparty to an EFC may elect to terminate an EFC to assert any netting or set-off rights, or enforce on any validly held credit support or other security. However, the solvent party cannot expect the insolvent party to continue performance of any uneconomical energy trading contract while it restructures. Further, the solvent party cannot expect any sort of priority claim for losses it has suffered as a result of any failure of an insolvent party to perform under an energy trading contract.