

THIS EDITION

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New developments in netting law

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Two recent developments in **Canadian close-out netting law** will be of interest to entities that are parties to derivatives, securities loans, repos and other financial contracts with **Canadian counterparties**. The first development is the stay order granted by the Quebec Superior Court in the subsequently aborted corporate plan of arrangement proceedings with respect to Abitibi- Consolidated Inc. an order which stayed the termination of contracts including eligible financial contracts. The second is amendments made to the Canadian Deposit Insurance Corporation Act that, once brought into force, will modify the eligible financial contracts safe-harbour in situations where the government establishes a bridge institution.

Abitibi CBCA plan of arrangement order has implications for eligible financial contracts

Earlier this year Abitibi-Consolidated Inc. (Abitibi) and various related entities proposed to enter into an arrangement with certain classes of its creditors relying on the plan of arrangement provisions in the *Canada Business Corporations Act* (CBCA). It is unusual to propose a corporate plan with respect to a company's debt. The CBCA plan of arrangement provision is not fundamentally an insolvency law. The procedure is most often used to restructure securityholder relationships within solvent companies and that is the primary intention. Restructurings involving insolvent entities are typically done under the *Companies' Creditors Arrangement Act* (CCAA). However, on rare occasions, the corporate proceeding is used by corporations that are insolvent. While the CBCA requires that a corporation be solvent to use the proceeding, courts have "finessed" this requirement by holding that it is satisfied as long as one of the applicant companies is solvent (even where the applicant is often a corporation newly established to take part in the plan) and the insolvent companies will emerge solvent from the plan.

Abitibi, which was insolvent, determined to use the corporate proceeding to restructure not only its relationship with bondholders but also with its term lenders, in the belief that it would be a more expedited procedure than a CCAA proceeding.

The court has jurisdiction under s.192 of the CBCA to make interim orders to facilitate the plan. The court in the Abitibi proceeding made an interim order that looked very much like the type of order a court would make in a CCAA proceeding. Included in the order was a temporary stay (until the hearing date for approval of the arrangement) against any person (not just the bondholders and term lenders) accelerating or terminating any contract with any of the Abitibi entities. Unlike the orders granted under the CCAA, however, there was no exemption for eligible financial contracts with the Abitibi entities.

The Quebec Superior Court in its reasons associated with the order does not deal with eligible financial contracts except to note that the orders requested “exclude from their application swap or derivative transactions or eligible financial contracts”. However, the order itself did not exclude all eligible financial contracts from the stay. It only excluded eligible financial contracts with persons “other than the Abitibi parties”. The intention here was seemingly not to interfere with the operation of credit default transactions having Abitibi as a reference entity or other eligible financial contracts between third parties where termination may have been triggered by an Abitibi default.

The order made in *Abitibi* is in contrast to the decision of the Alberta Court of Queen's Bench in *Re Enron Canada* (2001), 31 C.B.R. (4th) 15 (Alta. Q.B.). In that case, a CBCA plan of arrangement application was brought in which the applicant sought a stay of termination rights under contracts that would have been classified as "eligible financial contracts" under the CCAA. Parties to such contracts had contractual rights to terminate based on the Chapter 11 filing of the applicant's parent corporation or other credit events affecting the parent corporation, which was the applicant's credit support provider. The applicant argued that it was solvent and that it could remain so if a stay was granted to give it time to renegotiate credit support arrangements with its counterparties. The court rejected the application on the basis that it was not appropriate to interfere with the contractual rights of the parties and that the public policy against interfering with close-out and netting rights in the case of insolvent counterparties applied as well to solvent counterparties seeking to reorganize.

The very fact that the Abitibi order was made raises an issue for close-out netting. It is important to note, however, that the court did not hear arguments from any affected parties regarding the application of the order to eligible financial contracts and it was not the focus of Abitibi's submissions to the court. Also, the *Enron Canada* decision was not before the court. An appeal of the order, including the stay, was launched by the term lenders, but not parties to any EFCs specifically. The order became moot a little over a month after it was made when Abitibi filed under the CCAA, it having become apparent that the corporate plan would not succeed. Given the circumstances, the precedential value of the order on this issue is not as great as that of the *Enron Canada* case.

If, as this case suggests, the courts will allow the CBCA plan of arrangement proceeding to be used by an insolvent corporation as an alternative to a CCAA proceeding to deal not only with bondholder claims but also claims of ordinary creditors such as term lenders, then it makes sense to treat the commencement of such a proceeding, at least where creditors' claims are involved, in the same way as other bankruptcy events of default. Parties may want to consult with their Canadian counsel to ensure that the bankruptcy event of default is drafted widely enough to capture this type of corporate proceeding. As noted, corporate plans are used in many situations that do not involve insolvent entities or claims of creditors, so not every plan of arrangement procedure should give rise to an event of default. We suggest that the triggering event be the commencement of a proceeding under corporate law that proposes to deal with the claims of any class of creditors.

Parties will be in a better position to challenge the type of stay order granted in Abitibi where they have a clear contractual termination right. That right does not have to be the commencement of the corporate proceeding of course. Parties could have rights to terminate based on other events. For example, very often the Canadian proceedings will be accompanied by a performance default, a cross-default or the commencement of a U.S. Bankruptcy Code proceeding with respect to the entity or its related entities, which may itself be a termination event or event of default.

Amendments to CDIC Act alter eligible financial contract protections

The *Budget Implementation Act, 2009* (Canada) S.C. 2009, c.2, passed on March 12, 2009, introduced amendments to the financial institution restructuring provisions of the *Canada Deposit Insurance Corporation Act* (CDIC Act) that will modify the stay exemption for close-out netting and collateral enforcement rights under eligible financial contracts (EFCs) with CDIC member institutions. These provisions are not yet in force and will come into effect by Order-in-Council.

Current close-out protections for EFCs in CDIC Act proceedings

A Canadian bank that is in financial difficulty could be subject to one of two types of order made under section 39.13(1) of the CDIC Act by the federal Cabinet on the recommendation of the Superintendent of Financial Institutions. These are (1) an order vesting the shares of the institution in CDIC and (2) an order appointing CDIC as receiver of the institution. These orders have different effects, but in both cases there is an automatic stay on termination or accelerating payments under contracts by reason only of (i) the federal member institution's insolvency, (ii) a default, before the order was made, by the federal member institution in the performance of its obligations under the agreement, or (iii) the making of the order. With respect to EFCs, however, there is the exemption to allow a counterparty to terminate, net and deal with financial collateral (the EFC exemption).

Amendments

The amendments will limit the ability to rely on the EFC exemption if a “bridge institution” is to be incorporated and the EFCs are to be assigned to the bridge institution. A bridge institution (described in more detail below) is a financial institution that could be established, when CDIC is appointed receiver of an institution, to take over some or all of the assets and liabilities of the member institution for a temporary period, presumably to facilitate a sale of the institution.

The CDIC Act will permit EFCs to be assigned to a bridge institution. If an order directing the incorporation of a bridge institution is made, then the counterparty cannot close-out an EFC if CDIC either (1) undertakes to guarantee unconditionally the payment of any amount due or that may become due in accordance with the provisions of the EFC by the member institution or (2) undertakes to ensure that all obligations arising from the EFC will be assumed by the bridge institution. The proposed language of this limitation on the EFC exemption is as follows:

- (7.1) If an order directing the incorporation of a bridge institution is made, the actions referred to in subsection (7) may not be taken by reason only that the order or an order appointing the Corporation as receiver is made in respect of the federal member institution or that the eligible financial contract is assigned to the bridge institution if the Corporation undertakes to
- (a) unconditionally guarantee the payment of any amount due or that may become due — in accordance with the provisions of the eligible financial contract — by the federal member institution; or
 - (b) ensure that all obligations arising from the eligible financial contract will be assumed by the bridge institution.

Unless and until a bridge institution is incorporated and CDIC makes one of those two undertakings, a party to an EFC is free to rely on the EFC exemption.

It is highly likely that a bridge institution incorporation direction and receivership order will occur at the same time so parties will likely know immediately if the EFC exemption can be relied on or not. Note also that this provision prevents reliance on the EFC exemption only if the EFC is terminated or accelerated by reason only of the making of the order to incorporate the bridge institution, the appointment of CDIC as receiver or the assignment of the EFC to the bridge institution, and not if the contractual trigger is the institution’s “insolvency” or a pre-proceeding default by the institution.

The amendments do not include a provision similar to that in the similar U.S. law to the effect that either all transactions with the counterparty or none of them must be assigned. Given that the term “eligible financial contract” is defined in the regulations to include individual transactions as well as any master agreements, a literal reading of subsection (7.1) could suggest that CDIC has the power to assign individual transactions under a master agreement, which in turn raises the spectre of cherry-picking. However, given that the purpose of the bridge institution provisions is to enhance the financial stability of institutions, this cannot be the intention of the provision. CDIC has confirmed to ISDA that it interprets the provision as applying to the master agreement and the underlying transactions as a single contract.

Recognizing that there is an ambiguity in the language, there is a chance that amendments to the Act will be proposed before the provisions come into effect to clarify that assignment of individual transactions is not permitted.

Implications of assignment to a bridge institution

If CDIC is appointed as receiver of the institution, the Cabinet, on the Finance Minister’s recommendation, can also direct the Minister to incorporate an institution designated in the order as a bridge institution. This would be a bank if the insolvent institution was a bank, a trust company if the insolvent institution was a trust company, etc. CDIC as receiver can transfer assets and liabilities of the institution to the bridge institution for such consideration as it determines. CDIC can be selective in determining what assets and liabilities are transferred. The protection that the creditors of the member institution have (if the obligations owed to them are not assumed by the bridge institution) is that the Act requires the consideration set by CDIC for the transferred assets to be “reasonable in the circumstances”.

If the EFCs are assigned to the bridge institution, then the parties to those contracts should consider the following. The bridge institution will not be an agent of CDIC or the federal Crown even though all the shares are owned by CDIC and it must act on the direction of CDIC. The bridge institution is intended to be a temporary entity. Its designation as a bridge institution is for two years (subject to possible renewal to a maximum of five years in total). CDIC is required, however, to provide the "financial assistance that a bridge institution needs in order to discharge its obligations ... as they become due". Consequently, if CDIC undertakes to have the bridge institution assume the obligations under transferred EFCs (and does not directly guarantee them), there is this assurance that the obligations will be satisfied while the bridge institution exists.

The AMF grants a temporary exemption order relating to the creation and marketing of CFDs

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In Decision No. 2009-PDG-0064 in the matter of *CMC Markets UK Plc* (June 16, 2009), the Quebec *Autorité des marchés financiers* (AMF) granted a temporary exemption to a London-based firm regulated by the UK Financial Services Authority from requirements under section 82 of the *Derivatives Act* (Quebec) (QDA) in connection with the offering of contracts for differences (CFDs) in Quebec. This is one of the first exemption decisions granted by the AMF since the coming into force of the QDA on February 1, 2009. The QDA regulates all activities with respect to OTC and exchanges traded-derivatives carried on in Quebec.

Section 82 of the QDA requires that a person other than a "recognized regulated entity" who "creates or markets a derivative" be qualified by the AMF (under rules which have yet to be prescribed) before the derivative is offered to the public (the Qualification Requirement). The person must also have the derivative authorized by the AMF (the Authorization Requirement). The Authorization Requirement is not currently in force.

In this decision, the AMF exempted the applicant firm from the Qualification Requirement in connection with the "creation and marketing" of CFDs through a proprietary electronic trading platform and through its Canadian affiliate which is registered as a dealer with the AMF and is a member of The Investment Industry Regulatory Organization of Canada (IIROC). The Canadian registered affiliate is responsible for KYC and suitability reviews on prospective counterparties.

The decision states that the applicant firm had previously furnished detailed information to the AMF relating to the terms and conditions of the products and associated risks, trading methods, execution and risk management systems, margin requirements, etc.

The decision is conditional on (1) the applicant firm conducting all CFD-related activities in Quebec through its electronic trading platform or through a registered representative of the Canadian registered affiliate, (2) the applicant firm, the Canadian registered affiliate and its registered representatives carrying on this business in compliance with applicable IIROC rules, requirements applicable to registered firms under the QDA and related regulations and any other derivatives-related rules applicable to their activities, (3) the applicant firm informing the AMF on a timely basis of any material changes to its business and of (4) any disciplinary actions against it, the Canadian registered affiliate or its registered representatives with respect to their CFD-related business, and (5) delivery on an annual basis of the applicant firm's audited financial statements and a statement of the number of CFDs entered into with Quebec counterparties over the preceding financial period.

The exemption is granted retroactively to February 1, 2009 and will expire automatically on the earliest of June 16, 2010 or the date of the coming into force of regulations implementing the Qualification Requirement.

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