Insolvency Institute of Canada
L'Institut d'insolvabilité du Canada

REPORT OF

THE TASK FORCE ON DERIVATIVES

The Insolvency Institute of Canada ("**IIC**") Task Force on Derivatives (the "**Task Force**") respectfully submits this report on behalf of the leading organization of insolvency professionals in Canada. A brief description of the IIC is attached to this Report as Schedule "A". The Report is based on the volunteer efforts of many members of the IIC.

The Task Force was convened to examine the treatment of derivatives and other eligible financial contracts (together, "**EFCs**") under Canadian insolvency law in response to the heightened international scrutiny directed at some derivatives as a result of the 2008 global financial and liquidity crisis. The Task Force has undertaken a comprehensive review of Canadian insolvency statutes. The Report is primarily focused on the EFC provisions of the *Bankruptcy and Insolvency Act*[1] ("**BIA**") and the *Companies' Creditors Arrangement Act*[2] ("**CCAA**"), the two main Canadian insolvency statutes that apply to the insolvencies of commercial enterprises. The Report also considers the EFC provisions under the *Winding-up and Restructuring Act*[3] ("**WURA**").

OVERVIEW

Canadian commercial insolvency law is part of the national framework legislation which is designed to minimize the impact of an insolvency event upon the Canadian economy and to promote a successful restructuring of business enterprises undergoing financial difficulties. A successful restructuring (whether under the same corporate structure, a new legal entity or through a sale of business operations as a going concern) optimizes value for stakeholders, saves jobs, supports communities that rely on local industries, protects the public from losing vital services and encourages the survival of more competitive industries. In the case of financial institutions, the restructuring is also effected to protect special stakeholders such as depositors or policyholders and minimize potential "runs on the bank" which would create instability in financial markets, impair overall liquidity in the financial world and increase systemic risk.

Insolvency law promotes a going concern restructuring of a viable business entity's affairs. When a business entity is brought under insolvency protection, the BIA and CCAA provide a broad stay of rights and remedies against the insolvent entity to encourage a going-concern restructuring of the business where possible. This broad stay is a fundamental tool of Canadian

[1] R.S.C. 1985, c. B-3, as amended.

[2] R.S.C. 1985, c. C-36, as amended.

[3] R.S.C. 1985, c. W-11, as amended.

restructuring insolvency laws. The stay in part prevents a forced liquidation of a struggling business by staying (a) secured and unsecured creditors from realizing on the assets of the insolvent entity and (b) solvent counterparties from terminating contracts with the insolvent entity. Similarly, the *Canada Deposit Insurance Corporation Act*[4] ("**CDIC Act**") provides a broad stay of proceedings and a process to allow the Canada Deposit Insurance Corporation ("**CDIC**") to attempt to restructure a deposit-taking financial institution.

The legislative reforms regarding EFCs under Canadian insolvency law have been piecemeal. EFC protection was introduced into the BIA beginning in 1992, followed by more extensive amendments to the Canadian insolvency laws which generally came into force in 1997 and 2009. Amendments were also made to the CDIC Act and the *Payment Clearing and Settlement Act*[5] ("**PCSA**") to deal with EFCs entered into by certain financial institutions.

The insolvency regime for EFCs consists of a series of exemptions from the law that ordinarily applies to contracts upon the commencement of insolvency proceedings. The EFC "safe harbours" primarily provide an exemption from the stay of proceedings to permit the termination of EFCs by the solvent counterparty, the determination of the net amount owing under the terminated EFCs, the realization upon financial collateral posted in respect of EFCs and protect the priority thereof.

At the outset, the exemptions under insolvency law for the termination and netting of EFCs were in part promulgated on the basis of concerns for certainty in financial markets and competitiveness vis-à-vis the United States and other global markets. After the safe harbour provisions were added to the United States *Bankruptcy Code*,[6] similar protections were added in Canada to ensure that the Canadian market kept pace with global markets. In addition, it was felt that an exemption from stays against termination of EFCs would provide solvent parties with certainty in their dealings, with the anticipated result of encouraging the availability of risk-hedging derivatives for all Canadian enterprises, including those in financial distress.[7]

EFC protection is a significant exception to the stay of proceedings under the CCAA and BIA. There are two main purposes of the EFC safe harbours: (i) to protect non-defaulting counterparties from the risk of increasing exposure to the insolvent counterparty under the EFC and (ii) to reduce systemic risk in Canadian and global financial markets. Non-defaulting counterparties may be at risk because, in certain instances, the amounts under the EFCs are very substantial and the value of the underlying products subject to EFCs are volatile in nature and can change dramatically during an insolvency proceeding. If the solvent counterparty to an EFC is subject to a stay of proceedings and therefore unable to terminate its EFCs with the insolvent counterparty, there is a risk that the value of such EFCs could deteriorate sufficiently (from the

[4] R.S.C. 1985, c. C-3, as amended.

[5] S.C 1996, c. 6, Sch., as amended.

[6] *U.S. Code*, title 11.

[7] Minutes of Proceedings and Evidence of the Standing Committee on Consumer and Corporate Affairs and Government Operations respecting Order of Reference from the House of Commons dated Tuesday June 18, 1991 – pre-study of Bill C-22, *An Act to enact the Wage Claim Payment Act, to amend the Bankruptcy Act and to amend other Acts in consequence thereof,* House of Commons, 3rd Sess, 34th Parl, Issue No. 5, September 3, 1991, Chairman Felix Holtmann, at 1017–1018. [CBA Submissions].

insolvent counterparty's perspective) to put the solvent counterparty at risk. Systemic risk may arise where the solvent counterparty is a systemically important institution or where the solvent counterparty has entered into EFCs with one or more other counterparties. In extreme cases, the failure of one counterparty could have a domino effect, where the failure of one counterparty, particularly a derivatives dealer, triggers the failure of a second counterparty who is also a derivatives dealer and the failure of the second counterparty could trigger the failure of others. Multiple insolvencies may cause a lack of liquidity in the financial sector and unavailability of credit to solvent enterprises and, ultimately, systemic risk. The systemic risk could spread to global markets and lead to world-wide financial instability and, in extreme cases, recession.

The 2008 global financial and liquidity crisis precipitated recognition by governments and regulators of the need for a better understanding and more comprehensive regulation of derivatives. At the Pittsburgh Summit in 2009, the G20, including Canada, committed to strengthening the regulation, supervision and infrastructure of the global financial system (the "**G20 Commitments**"). The G20 Commitments include a commitment to attempt to mitigate systemic risk, particularly in the area of over-the-counter ("**OTC**") derivatives, by increasing the transparency of the OTC derivatives market and ensuring more consistent treatment of derivatives in different jurisdictions. To limit systemic risk, the G20 committed in part to the development of an internationally coordinated and comprehensive regulatory framework to facilitate the central clearing of most OTC derivatives according to internationally accepted standards, including insolvency rules.

Recent Canadian federal legislative amendments have focused on meeting the G20 Commitments. Amendments to the PCSA and the CDIC Act were enacted in 2012 primarily to facilitate the clearing and settlement of OTC derivatives by central counterparties and to further facilitate the restructuring of insolvent financial institutions by CDIC.[8] At the provincial level, the Canadian Securities Administrators are introducing rules to regulate more closely the OTC derivatives market and to provide for the central clearing of OTC derivatives.

Combating systemic risk is an important goal. However, the goal of reducing systemic risk has to be balanced against important Canadian insolvency principles which encourage restructuring. The Task Force has considered the treatment of derivatives in Canadian insolvency law in this light. The Task Force is of the view that the current treatment of EFCs in the Canadian insolvency regime does not always strike the right balance between protecting against systemic risk and allowing insolvent commercial enterprises to restructure. The current regime may in some cases impede the restructuring of insolvent enterprises by placing too much emphasis on attempting to reduce systemic risk.

In other cases, the protections against systemic risk may be improved and the Task Force supports strengthening some of the EFC safe harbours. In particular, additional protections should be provided to ensure that EFC counterparties have better priority to financial collateral. This protection against systemic risk can be granted without impeding a restructuring.

[8] On June 27, 2012, the Task Force submitted to the Department of Finance its *Preliminary Review of Federal Legislative Changes to Accommodate Central Clearing of Over the Counter Derivatives*, which expressed its views on a preliminary outline of these amendments that was provided by the Department of Finance to the Task Force and other stakeholders for comment.

As currently drafted, the EFC safe harbours may in some cases deprive the insolvent estate of value to which the estate and its creditors should be entitled. Further, the EFC safe harbours may delay or prevent certain liabilities of the insolvent entity from being crystallized. The Task Force has made certain recommendations aimed at maximizing the value of the estate and enhancing the prospects of a restructuring of an insolvent enterprise without unduly increasing the potential for systemic risk.

In making its recommendations, the Task Force is cognizant of the fact that the global and Canadian regulators have reached a broad consensus that the EFCs entered into by most commercial enterprises pose little or no risk to major financial institutions and therefore do not give rise to systemic risk on a global scale. Global and Canadian regulators have accordingly determined that EFC transactions with commercial enterprise "end-users" of EFCs should be exempt from the mandatory central clearing regime that is being developed primarily for financial institutions.[9] The Task Force recognizes that there is still a potential for systemic risk arising as a result of the failure of a commercial enterprise. However, the Task Force is of the view that the emphasis solely on the potential for systemic risk, however remote, may in some instances be disproportionate given the impact that the EFC safe harbours may have on the ability of a commercial enterprise to restructure and on the recoveries of other creditors of the insolvent counterparty.

As noted above, EFCs receive special protection because (i) liabilities under EFCs are often based upon large notional amounts and (ii) the values of the underlying reference items and the financial collateral securing EFC obligations are highly volatile and significant fluctuation of these values can occur during an insolvency proceeding.

In addition, the EFC exemptions were introduced to make Canadian institutions competitive in the global derivatives market and to ensure Canadian enterprises have access to the global derivatives markets.

For these reasons, the Task Force does not recommend a repeal of the fundamental EFC safe harbour provisions under the BIA, the CCAA and, to the extent they are available in respect of a trading company, the WURA, but rather recommends a series of modifications to alleviate the EFC safe harbour provisions with a view to achieving a better balance between the objectives of insolvency legislation and financial risk.

The Task Force is making recommendations regarding the following broad categories:

A. Allow the termination of EFCs by the insolvent entity or its court appointed officer.

B. Allow the assignment of EFCs by the insolvent entity or its court appointed officer.

C. Prohibit walk-away clauses in EFC contracts.

D. Increase the priority of EFC financial collateral.

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[9] See Basel Committee on Banking Supervision & Board of the International Organization of Securities Commissions, *Margin requirements for non-centrally cleared derivatives* (Bank for International Settlements: September 2012) at p. 9; see also Canadian Securities Administrators, *CSA Consultation Paper 91-405, Derivatives End-User Exemption* (Canadian Securities Administrators Derivatives Committee: April 13, 2012).

E. Protect the central clearing of OTC derivatives.

F. Protect EFCs in receiverships.

The Report is presented from an insolvency point of view. The recommendations are primarily meant to promote restructurings and to preserve value for an insolvent commercial enterprise and its stakeholders. The recommendations should, however, be considered in light of the impact, if any, which they would have on the ability of Canadian financial institutions and solvent enterprises to access the global derivatives markets. Canadian EFC protections under insolvency law should be periodically reviewed in light of ongoing international legal developments.

RECOMMENDATIONS

<u>Termination of EFCs</u>

1. The prohibition on disclaimer or resiliation[10] of EFCs by the insolvent party in section 32(9) of the CCAA and section 65.11(10)(a) of the BIA should be repealed. If the solvent party does not terminate the EFC, the insolvent party should have the power to do so on the following basis:

    (a) the insolvent party should not be able to disclaim EFCs until 30 days after the insolvency filing.

    (b) at the end of the 30 day period, the same regime for disclaimer of agreements found in section 32 of the CCAA and section 65.11 of the BIA should apply to the disclaimer of an EFC, including a 30-day notice period and a 15-day objection period.

    (c) cherry-picking of EFCs during the disclaimer process should be expressly forbidden.

2. A receiver appointed under Part XI of the BIA, a trustee in bankruptcy and a liquidator appointed under the WURA should also have the power to disclaim EFCs 30 days after their appointment by the Court on the following basis:

    (a) a trustee in bankruptcy should have the authority under section 30 of the BIA, with the permission of the inspectors of the bankrupt estate, to disclaim an EFC in the same manner as an insolvent debtor can disclaim other contracts under section 65.11 of the BIA.

    (b) a receiver under Part XI of the BIA or a liquidator under the WURA should be able to apply to court on notice to the solvent counterparty to disclaim an EFC on providing 30 days' notice to the solvent counterparty. The solvent counterparty should be able to object in court to the disclaimer on the same grounds as for the disclaimer of other contracts under section 65.11 of the BIA.

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[10] To simplify the text, the terms disclaimer and disclaim will be used throughout this text to also mean resiliation and resiliate.

(c) cherry-picking of EFCs should also be expressly forbidden.

Assignment of EFCs

1. The prohibition on assignment of EFCs by the insolvent party in section 11.3(2)(b) of the CCAA and section 84.1(3)(b) of the BIA should be repealed.

2. An insolvent entity, a trustee in bankruptcy, receiver under Part XI of the BIA and a liquidator of an insolvent insurance company under Part III of the WURA should be able to apply to the Court for an order assigning an EFC pursuant to the process provided for the assignment of other contracts in the CCAA and BIA on notice of the court motion seeking the assignment to the non-defaulting counterparty and other affected parties which, except in the case of insurance company insolvencies, is not less than 30 days.

3. The non-defaulting counterparty should not be permitted to terminate an EFC from the date the court makes an order assigning the EFC or such later date as may be set by the court.

4. Cherry-picking of EFCs to be assigned should be expressly forbidden and all contracts associated with an assigned EFC should be required to be assigned as well.

Walk-Away Clauses

The solvent counterparty should not be able to refuse to make net termination payments to the insolvent party on termination of an EFC because of the commencement of insolvency proceedings or any steps taken during the insolvency proceedings, such as a disclaimer of an EFC by the insolvent counterparty. The BIA, CCAA and WURA should be amended to render ineffective any provisions in an EFC that have the effect of providing for or permitting anything on termination, disclaimer or assignment of an EFC that is, in substance, equivalent to a walk-away clause.

Financial Collateral

1. Financial collateral should have priority over the super-priority liens for (i) certain wages pursuant to sections 81.3 and 81.4 of the BIA, (ii) certain pension amounts pursuant to sections 81.5 and 81.6 of the BIA and (iii) the deemed trusts pursuant to section 227 of the *Income Tax Act* ("**ITA**"),[11] section 23 of the *Canada Pension Plan*[12] ("**CPP**"), section 86 of the *Employment Insurance Act*[13] ("**EIA**"), and substantially similar provisions of provincial legislation.[14]

2. Financial collateral should be limited to those listed assets that are posted with, pledged to or specifically assigned to the solvent counterparty or under the control of an entity other than the insolvent counterparty or its related entities or that are subject to set-off or

[11] R.S.C. 1985, c. 1 (5th Supp), as amended.

[12] R.S.C. 1985, c. C-8, as amended.

[13] S.C. 1996, c. 23, as amended.

[14] For example, section 20 of the Quebec *Tax Administration Act* ("**QTAA**"), R.S.Q. c. A-6.002, as amended.

netting rights with the solvent counterparty or where title to the assets has been transferred by the insolvent debtor pursuant to a title transfer credit support agreement.

<u>OTC Derivatives</u>

1. The definitions of "clearing house", "clearing member" and "margin deposit" in Section 95(3) of the BIA should be expanded to cover derivatives clearing houses clearing derivatives transactions.

<u>Receiverships</u>

1. The receivership provisions in the BIA should be amended to ensure that a court does not have the power to stay a solvent counterparty from terminating an EFC in accordance with its terms, calculating net termination values of an EFC and netting or setting-off and dealing with financial collateral in accordance with the terms of an EFC. Such an amendment would make the provisions in certain Model Receivership Orders mandatory rather than discretionary. The amendment would result in standard treatment of EFCs in all receivership proceedings across Canada, as well as harmonizing receiverships with bankruptcies.

2. Section 88 of the BIA should be amended to apply to receiverships under Part XI of the BIA. The BIA should protect financial collateral to ensure that financial collateral posted with or pledged to secure an EFC is not primed by charges granted pursuant to a receivership order, including provisions granting a super-priority charge to a receiver in respect of the receiver's borrowings and the receiver's and other professional's fees.

DISCUSSION OF RECOMMENDATIONS

A. Termination of EFCs by Insolvent Estate

In the context of amendments to the BIA and CCAA codifying the process by which an insolvent debtor may disclaim agreements, provisions came into force in 2009 to prevent the debtor from terminating an EFC. Section 65.11(10) of the BIA was introduced to prohibit an insolvent debtor seeking to restructure under the BIA proposal provisions from disclaiming certain types of contracts, including EFCs. Similarly, section 32(9) of the CCAA was introduced to prohibit a debtor company from disclaiming 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 is able to effectively rehedge its exposure on derivatives transactions. As currently drafted, there is no time limit imposed on the solvent counterparty's unilateral right to terminate an EFC, which has the potential to create problems during a restructuring.

The EFC exemption from the disclaimer power can create an impediment to a successful restructuring and does little, if anything, to minimize systemic risk. To restructure successfully, a business operation needs to be cleared of burdensome contracts, including EFCs, and be able to crystallize and compromise claims of creditors. Further, if the insolvent party is "in the money" on a net basis on its EFCs with a counterparty, it should also have the opportunity to benefit from the net termination values. The permanent stay on termination of an EFC by the insolvent counterparty and the possibility of a reliance by the solvent counterparty on walk-away clauses in the EFC (as discussed below) impede both these goals.

The inability to disclaim an EFC can create uncertainty for the insolvent party and may prevent it from realizing value, which is counterproductive to the objectives of the insolvency legislation. If no action is taken by the solvent party and the insolvent party is not allowed to take action, then the insolvent party may lose a valuable asset because of changes in the market. The products underlying an EFC are often volatile. Furthermore, the fact that the solvent party may take action at any time with little prior notice creates uncertainty for the insolvent party, as the extent of its debt load cannot be known with certainty until all contracts have been terminated or have expired. This situation can affect the chances of success of a restructuring proceeding.

The solvent counterparty's unilateral right to terminate the EFC need not be indefinite to protect against systemic risk. It is important that the insolvent enterprise be given an opportunity to attempt to restructure and emerge from the insolvency process as a viable business. The Task Force is therefore of the view that the insolvent counterparty should have the right to terminate the EFC after an appropriate period.

The Task Force is of the view that giving the debtor a right to terminate EFCs in accordance with the general contract disclaimer regime under the BIA and CCAA will balance the rights of the solvent counterparty and the potential for systemic risk with the need to facilitate a restructuring. The same process for the disclaimer of contracts by an insolvent debtor should apply to EFCs. This process requires the insolvent party to give 30 days' notice of its intent to disclaim a contract. Upon the commencement of the 30 day notice period, the other party to the contract has a 15 day period to object to the disclaimer of the contract by applying to the court for an order that the contract not be disclaimed. Since the termination of EFCs is not stayed, a 30 day notice period will also allow the solvent counterparty a relatively lengthy period of time during which it may terminate the EFC on a date of its own choosing.

Termination of certain derivatives contracts may require the solvent counterparty to rehedge its position. To facilitate re-hedging, the Task Force is of the view that the insolvent debtor should not be able to give notice of its intent to disclaim EFCs until 30 days after the date of the insolvency filing.

Further, the solvent counterparty would have an additional 30 days to re-hedge under the existing notice regime for the disclaimer of contracts. This would give the solvent counterparty a total of at least 60 days before an EFC can be terminated by an insolvent debtor. In section 32(4) of the CCAA and section 65.11(5) of the BIA, when deciding whether to allow a disclaimer, the court is to consider, among other things, whether the disclaimer would likely cause significant financial hardship to a party to the agreement. The court has the discretion to refuse to allow the disclaimer or to extend the 30 day notice period to protect the solvent counterparty from the disclaimer of any contract if financial hardship is an issue. Financial hardship could arise where a solvent counterparty to an EFC may experience difficulty in rehedging its position during the 60 day time period. In such circumstances, the court could refuse to allow the disclaimer or could extend the time period to minimize the financial hardship.

In addition to businesses attempting to restructure, the right to disclaim EFCs should also be available to a trustee in bankruptcy under the BIA, a receiver appointed under the BIA, and the liquidator appointed under the WURA.[15] An insolvent estate, even if not restructuring, should not, as a matter of policy, lose value merely because of the commencement of insolvency proceedings. This is contrary to the general goal of maximizing value for all stakeholders. Further, there is a need to crystallize claims against the estate where the solvent counterparty has an in-the-money position to allow for a timely distribution to the creditors.

A trustee in bankruptcy should have the authority under section 30 of the BIA, with the permission of the inspectors of the bankrupt estate, to disclaim an EFC in the same manner as an insolvent debtor can disclaim other contracts under section 65.11 of the BIA.

A receiver under Part XI of the BIA or a liquidator under the WURA should be able to apply to court on notice to the solvent counterparty to disclaim an EFC on providing 30 days' notice to the solvent counterparty. The solvent counterparty should be able to object in court to the disclaimer on the same grounds as for the disclaimer of ordinary contracts under section 65.11 of the BIA.

The right to disclaim would not apply to any EFC transactions that have been cleared.

Members of the Task Force are of the view that the disclaimer regime should not permit an insolvent entity, trustee in bankruptcy, receiver or liquidator to cherry-pick valuable EFCs. Cherry-picking is unfair to the solvent counterparty and has the potential to provide certain creditors of the estate with an undeserved windfall at the solvent counterparty's expense. The disclaimer of EFCs should be permitted only where all EFCs with the same solvent counterparty are also disclaimed. This will prevent the insolvent entity from terminating only in-the-money contracts with the solvent party and impair the netting of obligations under other EFCs with the same counterparty. The Task Force recommends that the language used in section 39.15(7.2) of the CDIC Act be used as a guide to prevent cherry-picking.[16]

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[15] The IIC has previously recommended significant amendments to the WURA, including restricting its application to financial institutions. For a detailed review of the WURA recommendations, see the Insolvency Institute of Canada's *Winding-Up and Restructuring Act: Recommendations for Reform* (June 14, 2002).

[16] Section 39.15(7.2) of the CDIC Act provides as follows:

> The Corporation may assign to a bridge institution eligible financial contracts — including any claim under such contracts — that are between a federal member institution and an entity or any of the following entities provided that the Corporation assigns all of those eligible financial contracts to the bridge institution:
>
> (a) another entity that is controlled — directly or indirectly — by the entity;
>
> (b) another entity that controls — directly or indirectly — the entity; or
>
> (c) another entity that is controlled — directly or indirectly — by the entity referred to in paragraph (b).

Recommendations on Termination of EFCs

1. The prohibition on disclaimer of EFCs by the insolvent party in section 32(9) of the CCAA and section 65.11(10)(a) of the BIA should be repealed. If the solvent party does not terminate the EFC, the insolvent party should have the power to do so on the following basis:

   (a) the insolvent party should not be able to disclaim EFCs until 30 days after the insolvency filing.

   (b) at the end of the 30 day period, the same regime for disclaimer of agreements found in section 32 of the CCAA and section 65.11 of the BIA should apply to disclaimer of an EFC, including the requirement that 30 days' notice be given and the right of a solvent counterparty to object within 15 days of the provision of such notice.

   (c) cherry-picking of EFCs during the disclaimer process should be expressly forbidden.

2. A receiver appointed under Part XI of the BIA, a trustee in bankruptcy and a liquidator under the WURA should also have the power to disclaim EFCs 30 days after their appointment by the Court on the following basis:

   (a) a trustee in bankruptcy should have the authority under section 30 of the BIA, with the permission of the inspectors of the bankrupt estate, to disclaim an EFC in the same manner as an insolvent debtor can disclaim other contracts under section 65.11 of the BIA.

   (b) a receiver under Part XI of the BIA or a liquidator under the WURA should be able to apply to court on notice to the solvent counterparty to disclaim an EFC on providing 30 days' notice to the solvent counterparty. The solvent counterparty should be able to object in court to the disclaimer on the same grounds as for the disclaimer of ordinary contracts under section 65.11 of the BIA.

   (c) cherry-picking of EFCs should also be expressly forbidden.

B. Assignment of EFCs

In the context of amendments to the BIA and CCAA codifying the process by which an insolvent debtor may assign agreements, provisions also came into force in 2009 to prevent an insolvent debtor from assigning an EFC. Section 84.1(3)(b) of the BIA was introduced to prohibit a trustee in bankruptcy (and, by virtue of section 66 of the BIA, an insolvent debtor seeking to restructure under the BIA proposal provisions) from assigning an EFC. Similarly, section 11.3(2)(b) of the CCAA was introduced to prohibit a debtor company from assigning an EFC. The reason for including EFCs in the list of contract types exempted from the forced assignment power was to permit the solvent counterparty to control who is the new counterparty in a derivatives transaction.

The ability to assign EFCs would preserve and maximize value for the insolvent estate and may increase recoveries to creditors. The right to apply to court for an order assigning an EFC would most likely be used in the context of a sale of an entire book of business or a sale of a whole business, including EFCs entered into by the previous owner to hedge certain risks faced in that industry.

The right to assign EFCs is particularly important for Canadian insurance companies. Many Canadian insurance companies are major financial institutions. These companies have significant derivative books of business, particularly in their "dynamic hedging" programs for interest rates, equities and other risks. A major task of a liquidator of an insurance company appointed under Part III of the WURA is to seek to restructure the insolvent company's business portfolio so that it can be acquired by another insurance company. This maximizes value and protects policyholders. This objective is very similar to a restructuring of other financial institutions such as banks.

The court motion seeking an assignment of EFCs should be subject to the normal assignment provisions in the BIA and the CCAA, including evidence of the ability of the assignee to perform under the EFC, the assignee being an appropriate person to be assigned the rights and obligations under the EFC and the assignee curing any outstanding monetary defaults[17] under the EFC within the time fixed by the court.

To allow the solvent counterparty ample time to consider the proposed assignment and determine whether it can accept the proposed assignee, the notice of motion seeking an order assigning the EFC should be made on at least 30 days' notice to the solvent counterparty. During that period, the solvent counterparty will be able to terminate the EFC if it is not satisfied with the information provided to it and the court or if it does not accept the proposed assignee as the new counterparty. This termination right would survive until the court makes an order assigning the EFC or such later date as may be set by the court.

In the case of insurance company insolvencies, the liquidator need not be limited to a 30-day notice period. The treatment of the sale of assets, including derivatives, in proceedings in respect of an insolvent insurance company should be similar to the treatment of such sales in insolvency proceedings in respect of other regulated financial institutions. To protect policyholders and the stability and confidence in financial markets, a liquidator may need to sell the whole book of business early in the liquidation process.

The right to seek court approval of an assignment of an EFC would not apply to any EFC transactions that have been cleared.

For the same reasons as for the termination of EFCs, there should not be any cherry-picking on the assignment of EFCs with the same counterparty and all contracts associated with an assigned EFC should be required to be assigned as well.

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[17] Other than monetary defaults triggered by the debtor's insolvency, failure to meet financial covenants, accessing the relief provided by an insolvency statute, or other similar default.

Recommendations on the Assignment of EFCs

1. The prohibition on assignment of EFCs by the insolvent party in section 11.3(2)(b) of the CCAA and section 84.1(3)(b) of the BIA should be repealed.

2. An insolvent entity, a trustee in bankruptcy, receiver under Part XI of the BIA and a liquidator of an insolvent insurance company under Part III of the WURA should be able to apply to the Court for an order assigning an EFC pursuant to the process provided for the assignment of other contracts in the CCAA and BIA on notice of the court motion seeking the assignment to the non-defaulting counterparty and other affected parties which, except in the case of insurance company insolvencies, is not less than 30 days.

3. The non-defaulting counterparty should not be permitted to terminate an EFC from the date the court makes an order assigning the EFC or such later date as may be set by the court.

4. Cherry-picking of EFCs to be assigned should be expressly forbidden and all contracts associated with an assigned EFC should be required to be assigned as well.

C. Prohibition of Walk-Away Clauses

In a typical derivatives contract, when the contract is terminated, the party who is “out of the money” must pay the party who is “in the money.” However, clauses are sometimes, though rarely, included in EFCs which override the typical provision by affording one counterparty the right to walk away from a termination payment that would otherwise be due to the other counterparty when the second counterparty commits certain specified defaults, including becoming subject to insolvency proceedings (such provision a “**walk-away clause**”).

The EFC safe harbours were not intended to create a benefit for solvent counterparties. The EFC safe harbours were first suggested as a means to facilitate the termination of EFCs on a timely basis where one counterparty has become the subject of insolvency proceedings and were intended to benefit both the solvent and insolvent counterparties. The provision permits the solvent counterparty to terminate an EFC at market price, and gives rise to a net amount that may well be payable to the insolvent counterparty, rather than to the solvent counterparty. The exemption from the stay facilitates the determination of a fixed and certain value to the EFC and the right of both counterparties to collect such amount, just like an amount owed under any other contract at the time of the stay.[18]

Walk-away clauses have the potential to create significant windfalls for the counterparties that have the benefit of such clauses while causing significant harm to defaulting (insolvent) counterparties and their creditors. Walk-away clauses are disproportionately favourable to the non-defaulting counterparty and do not protect against systemic risk. The BIA, CCAA and WURA should be amended to render ineffective any provisions in an EFC that have the effect of providing for or permitting anything that is, in substance, equivalent to a walk-away clause.

[18] CBA Submissions, *supra* note 7.

Certain provisions of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*[19] ("**Dodd-Frank Act**") recently enacted in the United States provide that no walk-away clauses shall be enforceable with respect to certain covered financial companies.[20]

Walk-away clauses should be prohibited under the BIA, CCAA and WURA. The capital adequacy requirements published by the Office of the Superintendent of Financial Institutions require certain financial institutions to disregard EFCs that include walk-away clauses for purposes of measuring the financial institution's regulatory capital and for calculating netting in respect of same.[21] Even if the capital adequacy rules are sufficient to prevent certain financial institutions from inserting walk-away clauses in their EFCs, many derivatives dealers and other persons carrying on business through trading or entering into derivatives may not be subject to the same or similar capital adequacy rules. A standard rule for all EFCs should apply.

Prohibiting walk-away clauses will make the EFC safe harbours more consistent with Canadian insolvency law principles and the initial justification for the EFC safe harbours.

Recommendation on Prohibition of Walk-Away Clauses

1. The solvent counterparty should not be able to refuse to make net termination payments to the insolvent party on termination of an EFC because of the commencement of insolvency proceedings or any steps taken during the insolvency proceedings, such as a disclaimer of an EFC by the insolvent counterparty. The BIA, CCAA and WURA should be amended to render ineffective any provisions in an EFC that have the effect of providing for or permitting anything on termination, disclaimer or assignment of an EFC that is, in substance, equivalent to a walk-away clause.

D. Financial Collateral

The EFC safe harbours in the BIA, CCAA and WURA permit a solvent counterparty to realize upon financial collateral notwithstanding any stay resulting from the commencement of insolvency proceedings.[22] The protection for financial collateral came into force in September 2009.

Canadian insolvency law purports to give a solvent counterparty almost unlimited rights to enforce on its interests in financial collateral. The EFC safe harbours permit "any dealing with financial collateral" including sale, foreclosure and set off. Further, section 88 of the BIA provides that no order may be made under the BIA in relation to a bankruptcy or a proposal if the

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[19] Pub. L. 111-203; H.R. 4173.

[20] Dodd-Frank Act, s. 210(c)(8)(F). The U.S. courts have also not supported clauses which are in effect walk-away clauses: *Lehman Bros. Holding Inc. v BNY Corporate Trustee Servs. Ltd.*, 2010 BL 14861 (2010, U.S. Brtcy. Ct., S.D.N.Y.); *In Re Lehman Brothers Special Finance Inc. v Ballyrock ABS CDO 2007-1 Limited et al.*, 452 B.R. 31 (2011, U.S. Brtcy. Ct., S.D.N.Y.).

[21] Office of the Superintendent of Financial Institutions Canada, *Guideline: Capital Adequacy Requirements* (Effective Date: January 2013).

[22] The CDIC Act also provides solvent counterparties with a similar right to realize on financial collateral, subject to the one day stay that may result if CDIC is appointed receiver of the insolvent financial institution.

order would have the effect of subordinating financial collateral. Section 34(11) of the CCAA similarly provides that no order may be made under the CCAA if the order would have the effect of subordinating financial collateral.

Despite these clear pronouncements, the current provisions in Canadian insolvency law do not always clearly delineate who has priority over financial collateral. Section 81.3 of the BIA attributes an absolute priority to certain employee wage claims against current assets, subject only to certain deemed trusts in favour of the Crown[23] ("**Crown**"); and section 81.5 of the BIA attributes an absolute priority to certain pension claims against all the assets of the bankrupt, subject only to the employees' wage claims under section 81.3 of the BIA and certain of the Crown's deemed trusts. The assets potentially encumbered by the super-priority statutory lien for wage and pension claims against the insolvent could include financial collateral. Further, the Crown's deemed trust provisions could have priority over the solvent counterparty's rights to financial collateral.

The Task Force is of the view that the solvent counterparty should have a first ranking right to the financial collateral, ahead of the various statutory priorities for employees, pension plans and unremitted source deduction and withholding taxes, and that the above-mentioned statutory priorities should not affect the solvent counterparties' set-off or netting rights under EFCs. Unlike other security interests, financial collateral is one of the fundamental building blocks to protect against the potential for systemic risk arising in respect of EFCs.

The Task Force is also of the view that the definition of financial collateral as it relates to the type of security taken is too broad given the enhanced priority recommended for solvent counterparties with respect to financial collateral. To ensure that the Task Force's recommendation regarding the increased priority to financial collateral for solvent counterparties does not have a negative impact on employees, pension plans or the Crown, the scope of the security over financial collateral should be limited to collateral that is posted with or pledged to the solvent counterparty or in the control of an entity other than the insolvent counterparty, either as it exists on the date of the initial insolvency event or thereafter. These limits on the scope of the priority for the security over financial collateral will appropriately protect the interests of employees, pension plans and the Crown without the potential for increasing systemic risk.

One potential problem that the Task Force has identified with the current broad definition of financial collateral arises because a charge on financial collateral could resemble a floating charge on cash and securities which come into existence after an insolvency filing. In current banking practice, it is not unusual for a lender to offer an interest rate and/or foreign exchange swap as part of the financial arrangements under a credit agreement. These swaps qualify as EFCs. Generally, a lender will enter into a separate swap agreement with the borrower, but the swap will be secured by the same general security agreement or hypothec on the universality of the borrower's assets that also secures the credit facility. The collateral relied on for the general loan is mainly bank accounts, inventory and accounts receivable, which generate or provide the cash for repayment of the general loan. Allowing the borrower to use the same collateral for the swap as for the general loan improves the borrower's liquidity as the borrower does not need to

[23] The deemed trusts pursuant to section 227 of the ITA, section 23 of the CPP, section 86 of the EIA, and substantially similar provisions of provincial legislation. See *supra* note 14.

separately post cash or securities as collateral for the swap. The amounts owing from time to time under the swap generally do not reduce the credit line by the full amount of the swap.

Problems could arise in an insolvency where there the same general security agreement secures both the general loan and the EFCs granted pursuant to that loan. Upon the insolvency of the borrower, a lender that provides a swap that is secured by a general security agreement or an hypothec on the universality of a borrower's assets may take the position that the cash in the borrower's operating account or certain other current asset collateral under the general security agreement or hypothec is financial collateral. Interpreting the assets subject to the general security agreement as financial collateral could mean that the general lender, in its capacity as swap counterparty, is allowed to realize on the assets of the debtor including assets acquired by the debtor after the insolvency filing notwithstanding the stay that would normally apply to it in its capacity as secured creditor. Further, if the assets are financial collateral, the general lender in its capacity as swap counterparty potentially has priority over any charge to secure interim financing (colloquially, "**DIP**" financing) as well as over all assets acquired by the debtor after the insolvency filing (including any DIP financing drawn after the insolvency filing).

The current broad definition of financial collateral therefore has the potential to undermine many insolvent entities' restructuring efforts. The current definition of financial collateral could be interpreted in a way that would allow a solvent counterparty that has security under a general security agreement to seize the operating bank accounts or other securities of the insolvent counterparty at any time following default and, if the operating account is not seized, the solvent counterparty could require post-filing cash received by the borrower to be swept into an account controlled by the solvent counterparty to which the insolvent counterparty would not have access. The solvent counterparty could also argue that a court cannot grant a charge over the assets securing the swap (relying on CCAA s. 34(11)) and that these assets must be used to satisfy EFC obligations. This could have a serious impact on the restructuring efforts of the insolvent counterparty. The insolvent counterparty will need cash and current assets to operate and will likely need the ability to give security over its current assets in order to obtain interim financing.

The Task Force is particularly concerned about the scope of financial collateral given its recommendation that claims of a solvent counterparty to financial collateral be given priority over the claims of wage earners for unpaid wages, pensioners for unremitted pension contributions and taxing authorities for unremitted source deductions.

However, the limitation on the type of security or arrangement over financial collateral which can be given first ranking security status may lead some lenders to require from the borrower, in addition to a general security agreement or hypothec on the universality of the undertaking, a posting of collateral which could affect the liquidity needs of a solvent or insolvent party. Adoption of this recommendation should take this market risk factor into account.

<u>Recommendations for Financial Collateral</u>

1. Financial collateral should have priority over the super-priority liens for (i) certain wages pursuant to sections 81.3 and 81.4 of the BIA, (ii) certain pension amounts pursuant to sections 81.5 and 81.6 of the BIA and (iii) the deemed trusts in favour of the Crown

pursuant to section 227 of the ITA, section 23 of the CPP, section 86 of the EIA, and substantially similar provisions of provincial legislation.[24]

2. Financial collateral should be limited to those listed assets that are posted with, pledged to or specifically assigned to the solvent counterparty or under the control of an entity other than the insolvent counterparty or its related entities or that are subject to set-off or netting rights with the solvent counterparty or where title to the assets has been transferred by the insolvent debtor pursuant to a title transfer credit support agreement.

E. Central Clearing of OTC Derivatives

The Canadian regulators, in conjunction with other foreign regulators, are establishing international standard rules to require that the more standard OTC derivatives be cleared through derivatives clearing houses. The clearing houses will require their participating members to post collateral and make margin deposits to secure the obligations of the participating members to the clearing house.

Section 95 of the BIA deems bodies which clear securities and its members to be dealing at arm's length and exempts a securities clearing house from the rebuttable presumption that a payment has been made or that security has been taken with an intent to give the clearing house a preference over other creditors of the clearing member.

The Task Force is of the view that derivatives clearing houses should benefit from the same exemption under the BIA preference rule.

Recommendation for OTC Derivatives

1. The definitions of "clearing house", "clearing member" and "margin deposit" in Section 95(3) of the BIA should be expanded to cover derivatives clearing houses clearing derivatives transactions.

F. Receiverships under Part XI of the BIA

The provisions dealing with national receiverships and the appointment of a receiver by the Court pursuant to the BIA were introduced as part of the amendments that came into force in September 2009. Previously, the BIA did not provide for the appointment of a receiver by the Court, although it provided for the appointment of interim receivers in the context of a proposal, an application for a bankruptcy order or an intention by a secured creditor to enforce its security. Prior to 2009, courts in some provinces had given an expansive interpretation to the interim receivership provisions exercising their inherent jurisdiction such that interim receiverships were effectively full receiverships. In 2009, interim receivers were returned to their original role with limited powers and the ability to act only on an interim basis.

The amendments that came into force in 2009 did not deal with EFCs and no safe harbours apply in the receivership context. As such, while the CCAA and BIA contain exemptions for certain remedies in respect of EFCs in bankruptcy and restructuring situations, there is no mention of EFCs in the context of receiverships.

[24] For example, section 20 of the QTAA.

Prior to the amendments to the BIA, receivership was an equitable remedy which relied upon the broad jurisdiction of the courts in common law jurisdictions. The *Civil Code of Quebec*[25] and *Code of Civil Procedure*[26] do not specifically provide for the appointment of a receiver by the Court as an equitable remedy. Over time, receiverships have evolved. Courts outside of Quebec have used their inherent jurisdiction to impose a very broad stay of proceedings in a receivership to stay the termination of contracts, similar to a stay imposed by a court in a CCAA proceeding. This practice has continued to develop since 2009. The Quebec courts are sometimes reticent to grant a stay in such circumstances.

The Task Force has concluded that EFC safe harbours should be expressly provided in a receivership in the same fashion as elsewhere in the BIA and CCAA. Currently, protection of EFCs is solely at the discretion of the court exercising its inherent powers. Some provinces have developed Model Receivership Orders. Several Model Receivership Orders provide that the receivership stay does not apply in respect of an EFC,[27] but this protection is not uniform. For example, the Saskatchewan Model Receivership Order does not exempt EFCs from the receivership stay. In addition, Model Orders are discretionary. A court can choose to grant a broader stay in certain circumstances. The discretionary nature of the stay and the lack of uniformity among the provinces should be addressed to ensure that systemic risk is appropriately curtailed. Further, EFC safe harbours should be added to receiverships to ensure that regulators and market participants have the level of legal certainty they require for these types of rights.

The BIA provides that no order can be made in the context of a bankruptcy or proposal which has the effect of subordinating financial collateral. The BIA is silent on the effect of receiverships on financial collateral. The Model Receivership Orders developed, however, provide for a super-priority charge for the Receiver's and the Receiver's other professional fees over all the property of the debtor and a super-priority charge for the Receiver's borrowings over all the property of the debtor (collectively, the "**Receiver's Charges**"). The Receiver's Charges in the Model Receivership Orders generally have priority over every lien, charge, encumbrance and security interest except the environmental lien (BIA, s. 14.06(7)), the wages charge (BIA, s. 81.4(4)) and the pension charge (BIA, s. 81.6(2)).[28] Accordingly, the Receiver's Charges granted by a court generally prime financial collateral. The Receiver's Charges are therefore generally broader than the charges in the CCAA in favour of the monitor and DIP lenders. The

[25] S.Q. 1991, c. 64, as amended.

[26] R.S.Q. c. C-25, as amended.

[27] See section 9 of the Ontario Model Receivership Order, available on the webpage of the Ontario Court of Superior Justice, Commercial List, http://www.ontariocourts.ca/scj/en/commerciallist/; section 8 of the British Columbia Model Receivership Order, available on the website of the British Columbia Supreme Court, http://www.courts.gov.bc.ca/supreme_court/practice_and_procedure/practice_directions/civil/PD%20-%2016%20Model%20Receivership%20Order.pdf; and section 10 of the Alberta Model Receivership Order, available on the webpage of the Alberta Court of the Queen's Bench, http://www.albertacourts.ab.ca/LinkClick.aspx?fileticket=SI1sMgHbIXw%3d&tabid=324&mid=839.

[28] See sections 17 and 20 of the Ontario Model Receivership Order; sections 16 and 19 of the British Columbia Model Receivership Order; sections 16 and 19 of the Saskatchewan Model Receivership Order; and section 16 and 19 of the Alberta Model Receivership Order. Note that the Alberta Model Receivership Order does not explicitly state that the statutory liens and charges for the environment, unpaid wages and unpaid pension amounts have priority over the Receiver's Charges.

Task Force is of the view that Receiver's Charges should not be permitted to prime financial collateral.

Recommendations for Receiverships

1. The receivership provisions in the BIA should be amended to ensure that a court does not have the power to stay a solvent counterparty from terminating an EFC in accordance with its terms, calculating net termination values of an EFC and netting or setting-off and dealing with financial collateral in accordance with the terms of an EFC. Such an amendment would make the provisions in certain Model Receivership Orders mandatory rather than discretionary. The amendment would result in standard treatment of EFCs in all receivership proceedings across Canada, as well as harmonizing receiverships with bankruptcies.

2. Section 88 of the BIA should be amended to apply to receiverships under Part XI of the BIA. The BIA should protect financial collateral to ensure that financial collateral posted with or pledged to secure an EFC is not primed by charges granted pursuant to a receivership order, including provisions granting a super-priority charge to a receiver in respect of the receiver's borrowings and the receiver's and other professional's fees.

September 26, 2013

SCHEDULE "A"

The Insolvency Institute of Canada/L'institut d'insolvabilité du Canada

The Insolvency Institute of Canada is Canada's premier private sector insolvency organization. The Institute is a non-profit organization dedicated to the recognition and promotion of excellence in the field of insolvency. Its members are drawn from the most senior experienced members of the insolvency community in Canada. Membership is by invitation and is limited to 135 insolvency practitioners (trustees and lawyers) who are joined by representatives of regulatory and compensation bodies, major financial institutions and prominent members of the academic community.

The Institute provides a forum for leading members of the insolvency community to exchange ideas and share experiences with other members, senior representatives of the federal and provincial governments and members of the judiciary. The Institute supports and encourages research studies and analysis of restructuring, insolvency and creditors' rights issues. Since its inception, members of the Institute have always had prominent roles in the review and reform of Canada's insolvency legislation.

The Institute publishes papers on insolvency related topics in the annual Journal of the Insolvency Institute of Canada. Members regularly prepare and deliver presentations on technical, academic and professional matters at the Institute's Annual General Meetings. The Institute has commissioned research projects on important issues in Canada's insolvency and restructuring system. The Institute has established links with Canada's leading bankruptcy and insolvency judges. The Institute, in association with one of Canada's leading publishers, makes its collection of insolvency cases and materials available electronically.

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