2000 ABCA 239
Alberta Court of Appeal

Blue Range Resource Corp., Re

2000 CarswellAlta 1004, 2000 ABCA 239, [2000] A.W.L.D. 718, [2000] A.J. No. 1032, [2001] 2 W.W.R. 454, 192 D.L.R. (4th) 281, 20 C.B.R. (4th) 187, 228 W.A.C. 98, 266 A.R. 98, 87 Alta. L.R. (3d) 329, 99 A.C.W.S. (3d) 592

In the matter of the Companies' Creditors Arrangement Act, R.S.C. 1985 c. C-36, as amended; and in the matter of Blue Range Resource Corporation; Enron Capital & Trade Resources Canada Corp. (Appellant/Applicant) and Blue Range Resource Corporation, Humble Petroleum Marketing Ltd., Pricewaterhousecoopers Inc., in its capacity as Monitor, Royal Bank of Canada, National Bank of Canada, and First National Bank of Chicago (Respondents/Respondents) and TransCanada Energy Ltd. and International Swaps and Derivatives Association, Inc. (Intervenors)

Duke Energy Marketing Limited Partnership (Appellant) and Blue Range Resource Corporation and Humble Petroleum Marketing Ltd. (Respondents)

Engage Energy Canada, L.P. (Appellant/Applicant) and Blue Range Resource Corporation and Humble Petroleum Marketing Ltd., Pricewaterhousecoopers Inc., in its capacity as Monitor, Royal Bank of Canada, National Bank of Canada, and First National Bank of Chicago (Respondents)

Hunt, Berger, Fruman JJ.A.

Heard: February 29, March 1, 2000
Judgment: August 31, 2000 *
Docket: Calgary Appeal 99-18410, 99-18411, 99-18418

Proceedings: reversed (1999), 1999 CarswellAlta 652, 72 Alta. L.R. (3d) 196, 245 A.R. 172, 12 C.B.R. (4th) 173, [1999] 12 W.W.R. 616 (Alta. Q.B.)

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No counsel present for National Bank of Canada, Royal Bank of Canada and First National Bank of Chicago.
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S.E. Dunphy, for International Swaps and Derivatives Association, Inc.
J.G. Hanley, for TransCanada Energy Ltd.

Subject: Insolvency; Corporate and Commercial

APPEAL by purchasers from judgment reported at (1999), 72 Alta. L.R. (3d) 196, 245 A.R. 172, 12 C.B.R. (4th) 173, [1999] 12 W.W.R. 616 (Alta. Q.B.), dismissing claim for exemption from stay order under *Companies' Creditors Arrangement Act*.

The judgment of the court was delivered by *Fruman J.A.*:

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1 With mounting debt and brewing litigation, a company may be headed down the steep slope towards insolvency. The *Companies' Creditors Arrangement Act* permits the court to slow the company's descent by staying all actions and proceedings pending against it, and prohibiting creditors from terminating contracts. This permits the company to continue to operate while it attempts to restructure its financial affairs. But not all contracts are protected from termination. Despite an insolvency, creditors are entitled to terminate "eligible financial contracts" and set-off obligations. The legal issue in this appeal is whether long term natural gas supply contracts, entered into by a now insolvent gas producer, are eligible financial contracts. The answer to this question requires a foray into the perplexing financial world of derivatives.

FACTS

2 Blue Range Resources Corporation and its wholly-owned subsidiary, Humble Petroleum Marketing Ltd. [1] produce natural gas. As part of their business they have, over time, entered into long term contracts to sell natural gas to the appellants, Enron North America Corp. and its wholly-owned subsidiary Enron Canada, Duke Energy Limited Partnership, and Engage Energy Canada, L.P. [2] The appellants are risk management and gas marketing companies and are not end-users of the natural gas they purchase.

3 In early 1999, Blue Range and Humble found themselves on the brink of insolvency. They hastily made an *ex parte* application under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, commonly known as the *CCAA*, asking the court to stay all proceedings pending against them.

4 As is now the custom, the *ex parte* application asked for sweeping relief. The order granted was not disappointing. It stayed not only actions, but contractual obligations, restraining creditors from "accelerating, terminating, suspending, modifying or cancelling any such agreement ... exercising any rights of distress, recission or set-off or consolidation of accounts in relation to any indebtedness or obligation": Order of LoVecchio J. granted March 2, 1999, para. 3(b) (AB I at 7). The order provided an exception for "eligible financial contracts", as defined in s. 11.1(1) of the *CCAA*. Because those contracts were not stayed, a creditor was not prohibited from "terminating, amending or claiming an accelerated payment ... and setting off the obligations between Blue Range and such other party in accordance with [the contract's] provisions": Order, para. 3(c) (AB I at 8).

5 On March 19, 1999, the appellants applied to have their long term gas supply agreements declared eligible financial contracts. If their application succeeded, the contracts would be exempt from the *CCAA* stay order, permitting the appellants to terminate them and exercise any set-off rights provided in the agreements. LoVecchio J. decided that the agreements were not eligible financial contracts and dismissed the applications. I conclude that the agreements are eligible financial contracts.

THE *COMPANIES' CREDITORS ARRANGEMENT ACT*

6 The *CCAA*, which has become increasingly popular in recent years, provides a structured environment in which large insolvent companies continue to carry on business and retain control over their assets while their creditors, shareholders and the court consider a plan or compromise. See *Quintette Coal Ltd. v. Nippon Steel Corp.* (1990), 2 C.B.R. (3d) 303 (B.C. C.A.); *Re Lehndorff General Partner Ltd.* (1993), 17 C.B.R. (3d) 24 (Ont. Gen. Div. [Commercial List]); and *Re Smoky River Coal Ltd.* (1999), 175 D.L.R. (4th) 703 (Alta. C.A.); leave to reargue refused(1999), 175 D.L.R. (4th) 703 at 727 (Alta. C.A.). The process of compromise is overseen by a judge who has discretion to do what is necessary, within the confines of the legislation, to maintain the status quo while the negotiations, creditor approvals and reorganization take place. This "will enable the company to remain in operation for what is, hopefully, the future benefit of both the company and its creditors": *Re Northland Properties Ltd.* (1988), 73 C.B.R. (N.S.) 146 (B.C. S.C.) at 154 citing *Meridian Development Inc. v. Toronto Dominion Bank* (1984), 32 Alta. L.R. (2d) 150 (Alta. Q.B.) at 155. [3]

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7 To invoke the *CCAA*, a "debtor company", which has claims against it exceeding five million dollars, may apply to the court on an *ex parte* basis seeking the suspension of actions and contractual rights of creditors. The court may then order a comprehensive stay of proceedings under s. 11. Section 11(3) permits a court, on an initial application, to stay proceedings taken, restrain further proceedings, and prohibit the commencement of any actions against the debtor company for a period of 30 days. Typically, the initial order is later extended for a period deemed necessary by the court (s. 11(4)). The court's discretionary powers under s. 11 have been interpreted to restrain any conduct "the effect of which is, or would be, seriously to impair the ability of the debtor company to continue in business during the compromise or arrangement negotiating period": *Campeau v. Olympia & York Developments Ltd.* (1992), 14 C.B.R. (3d) 303 (Ont. Gen. Div.) at 309 citing *Quintette Coal Ltd. v. Nippon Steel Corp.*, *supra*, at 312. Accordingly, a court-ordered stay will usually prohibit creditors from terminating contracts with the debtor company.

8 Until 1997, the court had a broad discretion under the *CCAA* to order stays which interfered with a creditor's exercise of its contractual rights. That year the eligible financial contract provisions, which had been added in 1992 to s. 65.1(8) of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 (S.C. 1992, c. 27, s. 30), were imported into s. 11.1 of the *CCAA* (S.C. 1997, c. 12, s. 124) in order to harmonize the two insolvency statutes.[4] In its report to Parliament in 1991, the Standing Committee on Consumer and Corporate Affairs referred to termination and netting out provisions that had been exempted under United States bankruptcy law, and noted that "competitive considerations might require similar provisions here". The Committee went on to recommend the eligible financial contract exemption "that would allow certain financial swap and hedging agreements to be terminated where a notice of intention or a proposal has been filed" (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).

9 As a result of the addition of the eligible financial contract provisions, "no order may be made under [the *CCAA*] staying or restraining the exercise of any right to terminate, amend or claim any accelerated payment under an eligible financial contract" (s. 11.1(2)). This entitles a non-defaulting party to terminate an eligible financial contract and exercise rights of netting out or set-off, despite the *CCAA* proceedings. While the amendment permits a creditor to enforce the terms of the contract previously negotiated with the debtor company, it does not confer any extra powers; specifically s. 11.1(3) says "the setting off of obligations between the company and the other parties to the eligible financial contract, in accordance with its provisions, is permitted". The non-defaulting creditor who, on a net basis, is owed money, is deemed to be a creditor of the debtor company (s. 11.1(3)), and would participate in the *CCAA* proceedings on the same footing as other creditors. Presumably it would vote on the restructuring and ultimately receive whatever pro-rated payment other creditors receive.

10 Section 11.1(1) provides a comprehensive and intimidating list of the types of transactions that are eligible financial contracts:

> 11.1(1) in this section,
>
> > "eligible financial contract" means
> >
> > (a) a currency or interest rate swap agreement,
> >
> > (b) a basis swap agreement,
> >
> > (c) a spot, future, forward or other foreign exchange agreement,
> >
> > (d) a cap, collar or floor transaction,
> >
> > (e) a commodity swap,
> >
> > (f) a forward rate agreement,

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(g) a repurchase or reverse repurchase agreement,

(h) a spot, future, forward or other commodity contract,

(i) an agreement to buy, sell, borrow or lend securities, to clear or settle securities transactions or to act as a depository for securities,

(j) any derivative, combination or option in respect of, or agreement similar to, an agreement or contract referred to in paragraphs (a) to (i),

(k) any master agreement in respect of any agreement or contract referred to in paragraphs (a) to (j),

(l) any master agreement in respect of a master agreement referred to in paragraph (k),

(m) a guarantee of the liabilities under an agreement or contract referred to in paragraphs (a) to (l), or

(n) any agreement of a kind prescribed;

[Emphasis added.]

11 Here the key issue is whether the longer term gas supply contracts are forward commodity contracts under s. 11.1(1)(h).

THE AGREEMENTS

12 The agreements being considered in this appeal provide for long term natural gas sales by Blue Range or Humble to the appellants. They consist of:

a) Master Firm Gas Purchase/Sale Agreement dated June 13, 1994, as amended, between Enron and Humble (AB IV 406);

b) Master Firm Gas Purchase/Sale Agreement dated May 19, 1998, as amended, between Enron and Blue Range (AB VII at 921);

c) Gas Purchase Agreement dated June 25, 1996, between Duke and Humble (AB VI at 731-771);

d) Guarantee by Blue Range of Humble's obligations to Duke dated June 25, 1996 (AB VI at 772);

e) Gas Purchase Contracts dated July 1, 1991 and a Gas Purchase Letter Agreement dated December 1, 1992, between Humble and Engage (AB IV at 300 and 359);

f) Gas Transaction Agreement dated May 20, 1994, between Engage and Humble (AB IV at 390);

g) Guaranty Agreement by Blue Range of Humble's obligations to Engage dated July 1, 1994 (AB V at 581).

13 The contracts between Blue Range, Humble and Enron are master agreements which contemplate that the parties will enter into gas purchase and sale agreements from time to time (AB IV at 406; AB VII at 921). These subsequent agreements, which are in the form of confirmation letters, set out the terms and conditions of specific natural gas purchase and sale transactions (AB VI at 831; AB VII at 983 and 997). The master agreements contain termination provisions which are triggered by various events of default including "the failure by a party to make when due, any payment required under this Agreement ... an assignment for the benefit of creditors, a petition or proceeding under Bankruptcy law including the CCAA" (Clause 10.3, AB VII at 921). Both the Duke and Engage agreements are natural gas purchase and sale contracts with Humble, whose obligations are guaranteed by Blue Range. While the termination provisions

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in the Duke and Engage contracts do not mirror the Enron provisions, they too provide for termination in certain circumstances. All the agreements contain netting out or set-off provisions.

14 The agreements therefore fit within one of three categories: they are either individual gas purchase and sale contracts, master agreements which provide for gas purchase and sale contracts, or guarantees of gas purchase and sale contracts. The appellants contend that the individual gas purchase and sale contracts are forward commodity contracts, qualifying as eligible financial contracts under s. 11.1(1)(h) of the *CCAA*. It is conceded that if that is the case, each master agreement would be "a master agreement in respect of any agreement or contract referred to in paragraphs (a) to (j)", qualifying under s. 11.1(1)(k). Similarly each guarantee would be "a guarantee of the liabilities under an agreement or contract referred to in paragraphs (a) to (l)", qualifying under s. 11.1(1)(m). The key issue in this appeal, then, is whether the long term gas purchase and sale contracts are forward commodity contracts. If so, all the agreements are exempt from the *CCAA* stay provisions and may be terminated by the appellants.

THE CHAMBERS JUDGE'S DECISION

15 The chambers judge decided that the agreements were not forward commodity contracts within the meaning of s. 11.1(1)(h). Noting that the term "forward commodity contract" is not defined in the *CCAA,* he considered many different definitions provided by the parties and concluded "[b]ased on these sources one could define these items as almost anything or conclude that almost any contract fits" (AB I at 256). He expressed concern that a broad definition would defeat the object of the stay imposed in *CCAA* proceedings (AB I at 266).

16 The chambers judge observed that s. 11.1 is entitled "eligible financial contracts", not "eligible contracts" and considered the word "financial" in the title to be "very significant" and to be the "guiding principle" in giving a "purposeful meaning to the section in light of the statute as a whole" (AB I at 259-60). He decided that a distinction should be drawn between contracts whose purpose is to lead to the actual delivery of a commodity, which he called physical contracts, and contracts whose purpose is only financial and is not intended to lead to actual delivery of a commodity, which he called financial contracts. In his view, only the latter could be considered eligible financial contracts and "[t]he question whether contracts are one or the other is to be resolved by the intention of the parties" (AB I 260). Because the preamble to the Enron Master Firm Agreement referred to delivery and receipt of natural gas, he concluded that "the parties were intending this to be a contract which was 'physical' in nature as opposed to 'financial'" (AB I 266) and the agreement was not an eligible financial contract. He reached the same conclusion with respect to the Duke and Engage agreements (AB I 267).

FORWARD COMMODITY CONTRACTS

Hedges and Netting Out

17 Although "forward commodity contracts" are not defined in the *CCAA*, according to text writers they are merely "contract[s] to buy or sell an asset at a certain price on a future date": M. J. Bienenstock and P.M. Basta, "The Treatment of Derivatives under the Bankruptcy Code" in *Real Estate Workouts and Bankruptcies 1994*, (Practising Law Institute, 1994) 231 at 239. The long term natural gas supply contracts in this appeal fit within this general description. Put simply, they are negotiated contracts between private parties to buy and sell a specified quantity of gas at a certain or determinable price on a certain future date. According to the contracts, on the delivery dates Blue Range or Humble will deliver the gas to the purchaser at a specified delivery point, in exchange for the purchase price. The contracts therefore contemplate eventual physical settlement by the delivery of natural gas.

18 The agreements also serve an important financial purpose which is unrelated to physical or financial settlement; they are risk management tools, commonly known as "hedges". Blue Range or Humble agree to sell the gas at a predetermined price on a future date and assume the "short position". The buyer agrees to purchase the gas and assumes the "long position". The seller is looking for price certainty and limited downside exposure: Blue Range or Humble, who are guaranteed a particular purchase price, predict that the market price for gas will decline, and on the delivery date they

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will sell the gas at a price which is above market value.[5] The buyer assumes the risk of price fluctuations and predicts precisely the opposite: Enron, Duke and Engage gamble that the market price for gas will rise, and on the delivery date they will purchase the gas at a price that is below market value. See Bienenstock and Basta, *supra*, at 241-42.

19 Generally, no premium is paid when a long term gas purchase and sale contract is entered into, and on that day the contract has a zero value. But the price of gas fluctuates constantly, which in turn affects the value of the contract. Because gas is a commodity that trades on the New York Mercantile Exchange, its price and the value of an agreement providing for a future sale of gas are readily ascertainable at any given time. From the perspective of the purchaser, the contract will be "in the money" when the market value of gas exceeds the purchase price specified in the contract. It will be "out of the money" when the market value is less than the purchase price. The contract is therefore "marked to market" and may take on a positive or negative value, depending on the price of gas.

20 In order to further hedge their risk, many gas producers enter into a series of agreements with the same gas marketing and risk management companies, providing for the sale of gas at different prices, on different dates and at different points of delivery. Each of these contracts has its own calculable value. At any point in time, some of these will be "in the money", others "out of the money". Termination and netting out or set-off provisions permit the purchaser to terminate all the agreements upon a triggering event. The purchaser may then "calculate the value of all the transactions as of the termination date and ... net the positive and negative values to determine a lump sum termination amount payable by one party to the other": M.E. Grottenhaler and P.J. Henderson, *The Law of Financial Derivatives in Canada* (Toronto: Carswell, 1999) at 5.1.

The Derivatives Market

21 Contracts to sell things at some future date are not a new creation. Historians suggest forward commodity contracts have been around for some 800 years, since they first appeared at medieval trade fairs in the 12th century. See Richard J. Tweles and Frank J. Jones, *The Futures Game: Who Wins? Who Loses? Why?* (New York: McGraw Hill, 1987). One might wonder then why such basic contracts have taken on new prominence. The answer lies not in the nature of forward commodity contracts, but in the nature of the assets that are the subject of such contracts. It is necessary to consider these assets in the context of this case by reviewing the types of transactions commonly used in the natural gas industry, the manner in which they are actually traded and settled, and the consequences if a non-defaulting party cannot terminate contracts and net out obligations in the event of an insolvency. This analysis assists in understanding the purpose of the eligible financial contract provisions, and interpreting the words used in s. 11.1(1)(h).

22 Natural gas contracts trade through an exchange or board of trade in what is known as an exchange transaction, or between two negotiating parties in an off-exchange or over-the-counter transaction. There are, in turn, two main types of over-the-counter gas transactions: those which are physically settled by the delivery of gas, and those which are financially settled by cash payment.[6]

23 These instruments are all part of the global derivatives market. "Derivative products are investment tools whose value depends on, or is derived from, the performance of some underlying asset such as stocks, bonds, commodities, currencies or indices": G. Luinenburg and F. Soda, "The Enforceability of Over-the-Counter Derivative Contracts Under Canadian Insolvency Regimes" (1996) 12 B.&F.L.R. 41 at 43 [footnote omitted]. Forward commodity contracts and other derivatives have a financial value that can readily be calculated; they are commercial hedging contracts that can be used to manage various types of risk, including changes in commodity prices, exchange rates, interest rates and market risks.

24 Risk management companies, like the appellants, offer a wide range of cash-settled and physically-settled commodity products to customers, who may be producers, end-users or other financial intermediaries in the natural gas market. Natural gas market participants who do not ultimately consume the gas place little emphasis on the distinction between physically- and financially-settled transactions. Just as investors who dabble in the futures market do not

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anticipate waking up one morning to find a freight-car load of pork bellies on their front lawn, investors who deal in forward gas contracts do not intend to take physical possession of the gas.

25 Many of the trades among producers, gas marketers, risk managers and end-users involve buying and selling the right to take physical delivery of natural gas on a future date. Given the liquidity of the natural gas market, purchasers can readily offload their obligation to take delivery of gas under a physical contract by entering into a contract to make delivery of the same quantity of gas at the same point of delivery. These offsetting arrangements can be made with the original seller or a new party. The market operates like an exchange, as parties agree to make or take delivery, but settle their obligations by entering into offsetting contracts: Affidavit of David W. Richardson, sworn November 10, 1999 (Supp. AB II 18).

26 Although some end-user will eventually claim the gas, trades along the way are not settled by physical delivery. Instead, they are normally settled by "title transfers", using such systems as the NOVA Inventory Transfer System, which plays a role similar to a securities depository and transfer agent in the securities industry: Richardson Affidavit, *supra*, at 16. Participants transfer a nominated volume of gas from their Nova account to another participant's account. The transfer is done by book entry, without actual possession or physical delivery of gas. Like the active trading that takes place in other financial markets, the volume of gas traded on a daily basis far exceeds the amount of natural gas that actually flows through the system.

27 The appellants argue that an effective and fully functional termination, netting and set-off scheme that applies to all derivative instruments, including forward commodity contracts, is critical to the vitality of the derivatives market. A similar observation was made by Farley J. in *Confederation Treasury Services Ltd. v. Hees International Bancorp Inc.* (1997), 45 C.B.R. (3d) 204 (Ont. Gen. Div. [Commercial List]). He recognized that derivative contracts are a legitimate method of managing risk and as a matter of public policy should not be dealt with in a manner that affects their efficiency either in non-insolvency or insolvency situations. "If the right to terminate contemplated in the agreement ... is not enforceable, the whole structure of risk management for the swaps and other transactions is weakened or may fall apart": at 231 [citation omitted]. The effect of non-enforceability on the derivatives market is worth exploring.

28 The *CCAA* stay provisions create disparities among market participants. While the non-defaulting party is subject to the stay order and may not terminate its contracts, the debtor company suffers from no similar disability. Subject to the court's supervision, it may terminate and breach contracts with impunity, forcing the non-defaulting party to claim damages as an unsecured creditor in the *CCAA* proceedings. The ability to selectively repudiate contracts is disdainfully known as "cherry picking". The debtor company could, for example, retain "out of the money" transactions, speculating that they might improve in value, but knowing full well that it would not be able to pay if the market moved in the other direction. At the same time it might terminate "in the money" transactions, triggering a cash payment by the non-defaulting party. See Luinenburg and Soda, *supra*, at 65; Brenda Gonzalez-Hermosillo, "The Microstructure of Financial Derivatives Markets: Exchange-Traded versus Over-the-Counter", Technical Report No. 68 (Bank of Canada, 1994) at 64, online at *http://www.bank-banque-canada.ca/english/res/tr68-e.htm*.

29 Without enforceable termination and netting out provisions, the insolvent company maintains complete control and may repudiate a contract at any time without notice. Because the non-defaulting party cannot count on performance, it cannot effectively re-hedge its risk by entering into an offsetting contract incorporating similar terms. Given the volatility of the market, the non-defaulting party is exposed to excessive and unmanageable risk. [7]

30 Quite apart from the unfairness of cherry picking, other undesirable consequences follow. In order to determine credit availability, risk management companies account for "out of the money" transactions by deducting the value of "in the money" transactions. This practice is only appropriate if termination and netting out provisions are enforceable, and unaffected by an insolvency. [8] If forward gas contracts are not exempt from the *CCAA* stay provisions and no offsetting deductions are permitted, available credit quickly will be gobbled up. As a result, risk management companies will limit the capital they can allocate to this market, or ask cash-strapped gas producers to put up additional security to

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cover any short-falls. The unfortunate effect will be reduced availability of physical forward gas sales contracts to small producers, who are most in need of hedges to manage price risks. It will also encourage business to migrate to the United States, where physically-settled transactions are protected under United States bankruptcy law, [9] putting Canadian risk management companies at a competitive disadvantage. These results weaken the risk management structure within the derivatives market, and are contrary to the object of the eligible financial contract amendment.

Interpretation of the CCAA

31 An analysis of the language of s. 11.1(1) indicates that the eligible financial contract definition addresses derivative instruments and confirms that Parliament must have intended to protect the derivatives market from the uncertainties of insolvency.

32 The global derivatives market has shown phenomenal growth over the last decade. Derivative instruments, whose variety and number are limited only by ingenuity, are identified by a bewildering array of newly coined terms. [10] However, derivative instruments really consist of a couple of basic financial building blocks assembled to produce an almost infinite series of exotic-sounding products. See Clifford W. Smith, Charles W. Smithson and D. Sykes Wilford, *Managing Financial Risk* (New York: Harper & Row, 1990); see also Charles W. Smithson, "A LEGO Approach to Financial Engineering: An Introduction to Forwards, Futures, Swaps and Options", *Midland Corporate Finance Journal*, 4, no. 4 (Winter 1982) at 16-28. There are four basic building blocks: forwards and futures, [11] which in the case of commodities are physically settled, and swaps [12] and options, [13] which are financially settled. These interlocking pieces are refined, developed and combined to produce sophisticated products. A forward contract can be regarded as the most fundamental piece because other building blocks, the swap contract and the futures contract, for example, are no more than variations on forward contracts. See Richard Briffett, "An Introduction to Derivative Instruments and How They are Used", 1995, online at *http://www.law.emory.edu/~lawrld/deriv2.html.*

33 Parliament appears to have taken the building block approach to derivative instruments in stride in its formulation of s. 11.1(1). Each of the basic interlocking pieces seems to be included in the "eligible financial contract" definition: future and forward commodity contracts at s. 11.1(1)(h); commodity swaps at s. 11.1(1)(e); and options at s. 11.1(1)(j). A series of other well-recognized derivative instruments are included in the definition. But the derivatives market is always changing and the list of eligible financial contracts is not static. This is acknowledged in s. 11.1(1)(k) which includes combinations of other instruments, as well as derivatives or agreements similar to contracts referred to in other subsections. It seems, therefore, that derivative instruments of all varieties are embraced by the eligible financial contract definition.

34 Physically-settled forward commodity contracts are an important part of the derivatives market, both in their own right and as components of other instruments. Can it be said that on a proper reading they are excluded from the definition of eligible financial contracts? An interpretation of s. 11.1(h), viewed in the context of the other definitions in s. 11.1(1), indicates that is not the case.

35 The legislature is presumed to avoid "superfluous or meaningless words ... it does not pointlessly repeat itself or speak in vain"; "every word of a statute must be given meaning": R. Sullivan, *Driedger on the Construction of Statutes 3rd ed.* (Toronto: Butterworths, 1994) at 159-60; *Communities Economic Development Fund v. Canadian Pickles Corp.* (1991), [1992] 1 W.W.R. 193 (S.C.C.) at 209.

36 The definition of eligible financial contracts includes spot contracts [14] at (h), spot foreign exchange contracts at (c), and repurchase or reverse repurchase contracts [15] at (g). These contracts can only be settled by physical delivery, never by financial payment. If eligible financial contracts require cash settlement, these terms are robbed of any meaning. Therefore an across-the-board interpretation of eligible financial contracts that excludes physically-settled transactions cannot stand.

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37 Nor is there ambiguity in the expressions "eligible financial contract" or "forward commodity contract" to justify defining either term by reference to physical or financial settlement. It is only when a statute is fairly capable of two constructions that words of qualification can be used to resolve the established ambiguity or imprecision: *Howley v. Canada (Deputy Attorney General)* (1976), 69 D.L.R. (3d) 689 (S.C.C.) at 695. It is not necessary to require financial settlement in order to impart meaning on section 11.1(1)(h); these contracts are risk management tools and serve a financial purpose unrelated to settlement. The presumption of straightforward expression also obliterates the physical and financial settlement distinction. The term "forward commodity contract" is included in the section without any words of qualification. One could postulate that had Parliament intended to restrict s. 11.1(1)(h) to financially-settled commodity contracts, it could, for example, have defined those contracts as "a spot, future, forward or other commodity contract which is settled by cash payment and not by delivery of product".

38 Parliament addresses cash-settled commodity-based contracts in other subsections of s. 11.1(1). These include cap, collar or floor transactions [16] at (d), commodity swaps [17] at (e) and "any derivative ... in respect of ... an agreement or contract referred to in paragraph (a) to (i)" at (j). The last section is of particular importance, because its broad wording encompasses financially-settled derivatives of any other species of contract contemplated in s. 11.1(1), including derivatives of both physically- and financially-settled contracts. Because these sections deal specifically with cash-settled commodity contracts, "forward commodity contracts" in s. 11.1(1)(h) undoubtedly refer to something else — that something else must be physically-settled commodity contracts.

Restricting the Meaning of "Commodity"

39 But once the term "forward commodity contract" is interpreted to include physically-settled transactions, it could potentially include every contract to buy or sell on a future date any "thing produced for use or sale ... article of commerce ... [or] object of trade": *Oxford English Dictionary*, 2nd ed., *s.v.* "commodity". Even commercial contracts would not be protected from termination, making it impossible to maintain the status quo while a debtor company reorganized its affairs. Such a broad interpretation would defeat the *CCAA's* predominant purpose: preserving the insolvent company as a viable operation while reorganizing its affairs to benefit both the company and its creditors: *Meridian Development Inc. v. Toronto Dominion Bank*, *supra*, at 155; *Quintette Coal Ltd. v. Nippon Steel Corp.*, *supra*, at 309. Section 11.1(1) is an exception to a statutory protection which must "be interpreted in light of [the] underlying rationale and not be used to undermine the broad purpose of the legislation ...": Driedger, 3rd ed., at 369-70. See *National Trust Co. v. Mead* (1990), 71 D.L.R. (4th) 488 (S.C.C.) at 497-99. This dictates a narrower construction of provisions which are excepted from a stay order: *Re Smith Brothers Contracting Ltd.* (1998), 53 B.C.L.R. (3d) 264 (B.C. S.C.) at 272.

40 The chambers judge chose to sort the contracts by physical or financial settlement in order to limit the impact of s. 11.1(1)(h). That approach is inconsistent with the words used in the section and Parliament's purpose in enacting the eligible financial contract provisions. If all physically-settled instruments are protected from termination by the non-defaulting party, an important chunk of the derivatives market is vulnerable in an insolvency, weakening the Canadian risk management structure.

41 The chambers judge based his interpretation on the word "financial" in the term "eligible financial contract". Although a more restrictive interpretation of "forward commodity contract" may be warranted, any boundaries on its meaning must come from the words of the section rather than the label Parliament attached to the species of contracts. "Commodity" is the critical word, and it is not defined in the *CCAA*. The word "commodity" must be examined in the context of the legislation to see whether Parliament intended a broad dictionary meaning — to include a forward contract to buy or sell practically anything of value — or something less expansive.

42 Other statutes provide definitions which are considerably narrower than the dictionary definition. For example, the *Securities Act*, R.S.A. 1980, c. S-6.1 defines "commodity" at s. 1(b.01) to include:

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(i) any good, article, service, right or interest of which any unit is, from its nature or by mercantile custom, treated as the equivalent of any other unit;

(ii) the currency of any jurisdiction;

(iii) any gem, gemstone or other precious stone;

The *Commodity Futures Act*, R.S.O. 1990, c. C.20 defines Acommodity" in s. 1:

Acommodity" means ... any agricultural product, forest product, product of the sea, mineral, metal, hydrocarbon fuel, currency or precious stone or other gem ..."

43 A common feature in these definitions is that the articles are fungible in nature — each unit is interchangeable for another. They have no specific or defining characteristics and may easily be replaced. Grottenhaler and Henderson, *supra*, at 5-8 describe the similarities among the list of items contained in the definition of eligible financial contracts in s. 11.1(1):

Most of these transactions involve payments flowing between the parties depending on the fluctuation in the price or rate. Importantly, they also, for the most part, involve commodities or rights for which there is an active market. They are fungible in the sense that it is not difficult in most cases to find a replacement transaction and to do so in a relatively short time period.

44 Unlike leases and ordinary executory contracts whose markets change at a leisurely pace, derivative products are subject to a volatile underlying market: Luinenberg and Soda, *supra*, at 86. "[T]he spot market price for the underlying asset of a successful derivative security must be volatile and unpredictable with a sufficient (trading) volume to ensure convergence to a competitive equilibrium price": Sean M. O'Connor, "The Development of Financial Derivatives Markets: The Canadian Experience", Technical Report No. 62, (Bank of Canada, 1993) at 21.

45 Like the other items in s. 11.1(1), forward commodity contracts are financial hedges and risk management tools. Interpreting them in the context of the rest of the section requires that they share certain traits. The contracts listed in s. 11.1(1) deal with units that are the equivalent of any other unit. Therefore commodities must be interchangeable, and readily identifiable as fungible commodities capable of being traded on a futures exchange or as the underlying asset of an over-the-counter derivative transaction. Commodities must trade in a volatile market, with a sufficient trading volume to ensure a competitive trading price, in order that forward commodity contracts may be "marked to market" and their value determined. This removes from the ambit of s. 11.1(1)(h) contracts for commercial merchandise and manufactured goods which neither trade on a volatile market nor are completely interchangeable for each other.

Application

46 It is clear that natural gas meets this narrower definition of commodity. Unlike consumer goods which vary widely in size, style and quality, one mcf of gas is identical to another mcf of gas. Natural gas trades on a highly liquid and volatile market, and while its price fluctuates from moment to moment, that price is readily ascertainable. Forward gas contracts therefore have a calculable cash equivalent.

47 Since physically-settled forward commodity contracts are included in the definition of eligible financial contracts, and gas is a commodity, the next issue is whether the agreements in question are forward commodity contracts. As the term is not defined in the *CCAA*, industry and expert definitions provide valuable guidance.

48 Haedicke and Aronowitz, *supra*, footnote 12, at 88:74-75 define a "forward contract" for the energy industry as:

A customized contract to buy or sell a commodity for delivery at a certain future time for a certain price. It is customized by individual negotiations between two parties, rather than standardised and traded on a board of trade.

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The parties to the forward contract usually know each other, and in most cases the contract is settled by actual delivery of the commodity.

49 James Joyce, a specialist in energy risk assessment who provided an expert report in this case, identified the key elements of a forward commodity contract in the natural gas industry to include:

a) a buyer of natural gas;

b) a seller of natural gas;

c) a defined contract term longer than the next day;

d) a defined volume of natural gas;

e) a defined delivery and receipt point (including any transportation requirements, as applicable); and

f) a defined price or pricing mechanism. (AB VII at 1049.)

50 Not every contract involving the purchase and sale of natural gas is a forward commodity contract. For example, Joyce's definition would not capture standard gas utility contracts, which do not usually commit a consumer to purchase a specified volume of gas for a specified price. Instead they are demand driven, with consumers purchasing the amount of gas needed from time to time at prices which fluctuate depending on rates set by a regulatory authority.

51 The Haedicke and Aronowitz and Joyce definitions reasonably set out the requirements for a forward commodity contract in the natural gas industry. The gas purchase and sale contracts under consideration in this appeal, which are negotiated bilateral contracts as required in the Haedicke and Aronowitz definition, also contain all the elements referred to in the Joyce definition. Therefore the agreements are forward commodity contracts.

52 The final measure is to test the fairness of this result. A manufacturer of consumer goods selling specified products to particular customers may encounter serious financial obstacles if, in *CCAA* proceedings, customers are permitted to terminate contracts for the purchase of goods. The manufacturer may never find substitute purchasers with the same requirements, impairing its cash flow and ability to stay in business during the restructuring period. This defeats the purpose of the *CCAA*. But the same cannot be said of a gas producer whose long term gas supply contracts are terminated. Blue Range and Humble may readily sell their gas in the spot market, assuring them a source of income. In addition, they may negotiate new long term gas supply contracts, perhaps on more favourable terms.

53 The appellants are also fairly treated. Through the use of the termination and netting out provisions they may crystallize their losses, deal with their exposure through further hedging transactions and avoid piling on losses that are likely to arise in the volatile gas market. This permits them to continue to offer these risk management tools to small gas producers who are in need of them, and preserves the integrity of these financial instruments in the derivatives market.

SUMMARY

54 Eligible financial contracts in s. 11.1(1) include both physically-settled and financially- settled transactions. Restricting forward commodity contracts in s. 11.1(1)(h) to cash-settled contracts is contrary to the plain meaning of the section and inconsistent with Parliament's objective of protecting the risk management structure within the derivatives market. Nor is such a restriction necessary to achieve the purpose of the *CCAA*. While forward commodity contracts may be physically settled by the delivery of product, they must be restricted to contracts for fungible commodities which trade in a liquid and volatile market.

55 Natural gas is such a commodity. Each of the agreements under consideration in this appeal is an eligible financial contract because it is either a forward commodity contract (s. 11.1(1(h)), a master agreement in respect of a forward commodity contract (s. 11.1(1)(k)), or a guarantee of the liabilities under a forward commodity contract (s. 11.1(1)(m)).

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56 The appeal is allowed.

Supplementary reasons.

Berger J.A.:

57 Counsel will note that this judgment is styled "Reasons for Judgment Reserved". The label "Reserved" no longer has the significance it once had. The Court's policy set out in *Hutterian Brethren Church of Starland v. Starland (Municipal District No. 47)* (1993), 9 Alta. L.R. (3d) 1 (Alta. C.A.), at 15 and *R. v. Bonneteau* (1994), 24 Alta. L.R. (3d) 153 (Alta. C.A.), at 158 was abolished on September 1, 1999.

58 The effect of the new policy, which still permits circulation of draft reasons to members of the Court off the panel (for comment only), was stated as follows by Hetherington, J.A. in *R. v. F. (D.M.)* (1999), 139 C.C.C. (3d) 144 (Alta. C.A.):

> In the past this court has said that, so far as statements of law or principle are concerned, a reserved judgment which is not a dissenting judgment sets out views accepted by a majority of the members of the court. (See *Hutterian Brethren Church of Starland v. Starland No. 47 (Municipal District)* (1993), 9 Alta. L.R. (3d) 1, at 15, and *R. v. Bonneteau* (1994), 24 Alta. L.R. (3d) 153, at 158.) However, this is no longer the case. The practices of the court have changed. Now so far as statements of law or principle are concerned, a reserved judgment which is not a dissenting judgment sets out the views of a majority of the panel which heard the appeal. It can not be inferred that a majority of the members of the court share those views.

Appeal allowed.

Footnotes

* A corrigendun was issued November 30, 2000; the changes have been incorporated herein.

1 Blue Range and Humble are represented in this appeal by PriceWaterhouseCoopers Inc., in its capacity as monitor under the *CCAA*.

2 Both Enron companies are the North American merchant trading arms of Enron Corp., a Houston-based integrated natural gas and electricity company. These companies offer risk management services primarily related to the energy sector. Duke is a limited partnership carrying on business as a natural gas marketer in Alberta. Engage is the merchant trading arm of Westcoast Energy Inc. and The Coastal Corporation, and offers risk management services to entities operating in the energy sector. The appellants are joined in this appeal by two intervenors: TransCanada Energy Ltd. is Canada's largest domestic marketer of natural gas and other commodities; International Swaps and Derivatives Association, Inc. is the global trade association representing the world's major institutions in the privately negotiated derivatives industry.

3 Footnote deleted.

4 Similar "eligible financial contract" definitions were added in 1992 to s. 39.15(7) of the *Canada Deposit Insurance Corporation Act*, R.S.C. 1985, c. C-36 (S.C. 1992, c.26, s.11); and in 1996 to s. 22.1(2) of the *Winding-Up and Restructuring Act*, R.S.C. 1985, c. W-11 (S.C. 1996, c. 6, s.142).

5 As one might have guessed, Blue Range's and Humble's predictions were wrong. They overestimated the volume of gas they would produce and underestimated the market price for gas. The companies therefore did not receive market price for the gas they produced and also had to purchase gas in the spot market to honour their contractual commitments. These were significant contributing causes of the insolvency: Affidavit of Jeffrey Tonkin sworn March 2, 1999 (AB II at 4).

6 Enron calls financially settled transactions "derivative contracts" or "gas-based derivative contracts": Affidavit of P. R. Milnthorp dated March 19, 1999 (AB II at 16-17). This terminology is confusing. Forward commodity contracts are themselves considered to be derivatives. See, for example, Luinenburg and Soda, *supra*, at 43: "Well-known derivative products include ... *forwards*" [original emphasis]; Bienenstock and Basta, *supra*, at 239; "Examples of derivatives are forward contracts"; J.C.

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Hull, *Options, Futures and Other Derivatives* 3rd ed. (Upper Saddle River: Prentice Hall, 1997) at 1-2: "A *forward contract* is a particularly simple derivative .... A key variable determining the value of a forward contract at any given time is the market price of the asset" [original emphasis]; G. L. E. May, "Overview of Financial, Tax and Accounting Principles for Derivative Financial Instruments", Canadian Tax Foundation, 1995 Conference Report 29:1 at 29:3: "Generally, derivative financial instruments are contingent claims that give owners the obligation or right to buy or sell a quantity at a predetermined price in the future...."

7 Extreme volatility leads to roller coaster profits and losses, making the derivatives market a high stakes game that is not for the passive, the inexperienced or the faint of heart. These features of the market are well-recognized:
Q: What's the difference between being rich and being poor?

A: About 15 seconds, some days.
"What's the Difference on Wall Street", January 28, 1999, "Derivatives Humor for 1999 - January to August", Copyright 1996-1999 by The William Margrabe Group, Inc., online at *http://www.margrabe.com/Humor/Humor99.html.*

8 In fact this type of accounting will actually be prohibited for some market participants, like banks, that are required by regulation to maintain adequate capital. See for example Guideline A of "Guideline with respect to Capital Adequacy Requirements for Banks", issued by the office of the Superintendent of Financial Institutions. Without an unqualified legal opinion to the effect that termination and close-out netting provisions are effective on insolvency, participants who account for transactions in this fashion will be offside their capital requirements. See Grottenhaler and Henderson, *supra*, at 5.1-5.2.1.

9 United States bankruptcy law also exempts forward commodity contracts from the stay provisions; however, the exemption is based not only on the nature of the contract, but also on the nature of the market participant. Under the U.S. *Bankruptcy Code*, special protection is available to "forward contract merchants" (defined at 11 U.S.C. s. 101(26)), stockbrokers and financial institutions to terminate, net and set-off "forward contracts" (defined at 11 U.S.C. s. 101(25)) when the other party to the contract files a petition in bankruptcy. The provisions were designed to protect transactions involving forward contract merchants, rather than ordinary supply contracts between producers and end-users. So long as one of the parties is a forward contract merchant, the contract is exempted, whether it was entered into with a producer, end-user or third party: Sullivan & Cromwell opinion, March 31, 1999 (AB VII at 1060-61). Sullivan & Cromwell also expressed the opinions that Enron would be a "forward commodity merchant" and that the agreements to which it is a party in this appeal would be "forward contracts", within the meaning of the U.S. *Bankruptcy Code*: *id.* (AB VII at 1063).

10 The derivatives market has an argot of its own (not to be confused with an ARGO, which hedges the swap leg with puts). The lingo includes:

— for those with an alliterative bent: strips, straps, STRYPES, straddles, strangles and structures;

— for animal lovers: turtle trades, CUBS, ELKS, STEERS, COBRAs, hamster options, kangaroo bonds and naked dog baskets;

— for individualists: SLOBs, sticky floaters, ZENS, SPINs and hermaphrodite options;

— and for the remorseful investor: gilt strips.

See The William Margrabe Group, Inc.'s Derivatives Dictionary, Copyright 1996-2000 by The William Margrabe Group, Inc., online at *http://www.margrabe.com/Dictionary.html.*

11 Both future and forward commodity contracts are physically-settled. The essential difference between them is their manner of trading. A futures contract trades on an exchange or board of trade. The exchange's clearing house assumes the obligation of both the buyer and seller of the contract and guarantees the transaction, but requires market users to post collateral or "margin", and maintain minimum capital requirements. See Gonzalez-Hermosillo, *supra*, at 28-30. Forward contracts are off-exchange or over-the-counter transactions involving custom contracts negotiated between two parties. Market participants are end-users and dealers who deal directly with each other. Forward contracts are subject to more risks than exchange-traded contracts, including the risk that the contracting party will default on the original contract: *id.* at 59.

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12 A swap is no more than a series of forward contracts. A gas commodity swap contract is an agreement between two parties to buy or sell a stream of cash flows over a predetermined length of time. One party agrees to pay based on a fixed price, while the other agrees to pay based on a floating or market price. Because payments are measured by the difference in prices on the same notional volume of gas, the contracts are always financially-settled: Mark E. Haedicke and Alan B. Aronowitz, "Gas Commodity Markets" in *Energy Law and Transactions* Vol. IV (New York: Matthew Bender & Co. Inc., 1999) at 88:19.

13 An option holder pays a premium to acquire the right, but not the obligation, to purchase a specified volume of gas ata specified price, called the strike price, during a specified period of time. The value of the option will depend upon the price of the gas, which will fluctuate from day to day. An option to purchase gas at $2.50 per Mmbtu may have a negligible value if gas trades at $1.50 but will be worth more than $2 if gas trades at $4.50. The option holder need never exercise the option and acquire the gas, but for a more modest investment can benefit from the spread between the strike price and the market value. The holder has no exposure to risk from unfavourable price movements, other than a loss of the premium paid to acquire the option. See Laura J. Porterfield, "Derivative financial instruments: time for better disclosure", *The CPA Journal Online*, July 1994, copyright 1997 New York State Society of Certified Public Accountants, online at *http://www.nysscpa.org/cpajournal/old/15611641.htm*.

14 Spot contracts, used either in respect of commodities or foreign exchange, contemplate only physical delivery. That delivery is immediate in contrast to a future delivery. See *Black's Law Dictionary*, 6th ed. Time is not a variable and price fluctuations have no effect. As a result, spot contracts have no financial character and no means by which they may be settled in any way other than physical delivery of product, except perhaps by payment of a stiff penalty.

15 A "repurchase contract" or "repo" is "a contract to sell a security combined with a simultaneous agreement by the original seller to repurchase the security at a later date": Bienenstock and Basta, *supra*, at 257. It is a present-day sale combined with an agreement to repurchase the same security in the future. These transactions must be physically-settled by an exchange of cash for the return of the security. Financial settlement is never possible.

16 Caps, floors and collars are forms of commodity swaps. In a cap transaction, one party pays a single or periodic fixed amount and the other party pays periodic amounts based on the excess of a commodity price over a specified price; in a floor transaction, the other party pays periodic amounts based on the excess of a specified price over a commodity price. A collar transaction is a combination of a cap and a floor, where one party pays the floating rate commodity price on the cap and the other pays the floating rate commodity price on the floor. As with other swaps, payments are measured by the difference in prices, and the contracts are always financially-settled. See Schedule "A" to Stikeman, Elliott "Memorandum of Law for the International Swaps and Derivatives Association, Inc.", February 1998 (Supp. AB III at 260-61).

17 See footnote 12, *supra*.

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