

***LESSONS FROM THE ALBERTA COURT OF APPEAL
IN THE BLUE RANGE PROCEEDINGS PRESENTED
TO THE INTERNATIONAL ENERGY CREDIT ASSOCIATION
OCTOBER 2000 CONFERENCE***

Macleod Dixon
Barristers & Solicitors
3700 Canterra Tower
400 – 3rd Ave. SW
Calgary, Alberta, Canada
T2P 4H2
Attention: Howard A. Gorman
Telephone: (403) 267-8144
Fax: (403) 264-5973

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Prepared by: Howard A. Gorman¹

INTRODUCTION

The *Companies' Creditors Arrangement Act* ("CCAA") has been described as the Canadian equivalent to Chapter 11 proceedings under the *United States Bankruptcy Code*. Generally the CCAA is considered more "creditor friendly" than its American counterpart as proceedings typically move more quickly and with more creditor involvement in the restructuring proceedings.

The CCAA is a very short Act (a copy of the entire CCAA is included as Attachment 1) and as such, proceedings under the CCAA have largely developed through practice and precedent. Recent amendments to the CCAA provided additional direction with respect to the issues of set-off and the creation of certain classes of contracts that could not be stayed by Court Orders under the provisions of the CCAA.

BACKGROUND

Blue Range Resource Corporation ("Blue Range") was a small oil and gas producer headquartered in Calgary, Alberta. Management of Blue Range changed in late 1998 following a hostile reverse takeover. In early 1999, new management concluded that the Blue Range production assets, which were depleting, were insufficient to meet Blue Range long term supply obligations. As prevailing market prices had risen to a level in excess of the price Blue Range was receiving under these sales contracts, to perform its ongoing supply obligations, Blue Range was forced to purchase gas on the spot market at a significant loss.

On March 2, 1999, Blue Range (and various related subsidiaries) initiated proceedings and obtained an original Order from the Alberta Court of Queen's Bench under the provisions of the CCAA. The CCAA Order contained the usual provisions staying all third party claims, preventing all third parties from accelerating, terminating, suspending, modifying or cancelling any agreements and restraining third parties from exercising any rights of rescission or set-off.

At the time of the CCAA filing, Blue Range was supplying gas to various third party marketers under contracts which, because of rising prices, were significantly out of market. In accordance with standard industry practice, the purchase price for the gas delivered in any given month was to be settled on the 25th day of the following month (ie. March 25 for February deliveries and April 25 for March deliveries).

¹ The author is a partner at Macleod Dixon who practices primarily in the insolvency and restructuring area. This memoranda represents general principles only and is not intended to replace nor should it be relied upon in substitution for prompt, informed legal advice.

The fact that Blue Range would, at some point, seek to terminate its supply obligations was apparent and inevitable. After Blue Range obtained the CCAA Order on March 2, various marketers obtained Court approval to pay their March 25 payment obligations into Court pending determination of their rights of set-off. To no one's surprise, shortly after March 25, Blue Range unilaterally terminated its supply under these long term agreements transferring its production to the more lucrative spot market.

The mark to market damages incurred by the third party marketers as a result of Blue Range's termination of their supply contracts greatly exceeded (by more than 10 fold) the monies that would be owing for the February and March deliveries.

The affected marketers sought to off set any payment obligations for the gas received as against the damages arising from the premature termination and repudiation of their gas purchase agreements. Further, the marketers sought confirmation from the Courts that their master gas marketing / purchase agreements constituted "eligible financial contracts" within the provisions of the CCAA which would provide the marketers' enhanced rights of set-off and protection from the provisions of the CCAA stay Order.

At first instance, Mr. Justice LoVecchio of the Alberta Court of Queen's Bench rejected both of these arguments being advanced by the gas marketing companies. In his decisions, Mr. Justice LoVecchio was clearly concerned about the affect that finding in favour of the gas marketers would have on ordinary unsecured creditors and upon the ability of Blue Range (or any other marketer or producer) to effectively restructure its affairs under the CCAA.

Both of these matters were appealed to the Alberta Court of Appeal, whose decisions are included as Attachment 2 (set-off) and Attachment 3 (eligible financial contracts) respectively.

SET-OFF

Section 18.1 of the CCAA was recently amended to provide as follows:

18.1 Law of set-off to apply - The law of set-off applies to all claims made against a debtor company and to all actions instituted by it for the recovery of debts due to the company in the same manner and to the same extent as if the company were plaintiff or defendant, as the case may be.

The affected gas marketers argued that their obligation to pay for gas received was so closely related to the damages that they incurred following the Blue Range repudiation of the remainder of the term of those agreements that they were entitled to set-off their payment obligations as against those future damages. The Alberta Court of Appeal in overturning Mr. Justice LoVecchio and upholding the marketers' right of set-off agreed with this analysis. The Court noted that the Canadian Parliament in enacting Section 18.1 expressly endorsed a creditor's right of set-off in the CCAA proceeding and confirmed that such rights should be available to the gas marketers. It is significant to note that in the Blue Range appeal, the gas marketers were seeking

to set-off mark to market losses as against payment deliveries owing under the same master gas purchase agreement.

SET-OFF RECOMMENDATIONS

Based upon the Court of Appeal decision, we would generally recommend as follows:

- (a) ensure that you have a Master Agreement covering all trades. Your rights are enhanced where there is one Master Agreement rather than a series of agreements which, it may be argued, are unrelated;
- (b) ensure that your rights of set-off are specifically referenced in the Master Agreement;
- (c) if you have a series of agreements that you wish to be subject to rights of set-off, specifically reference the other agreements, the intended right of set-off between the series of agreements and explain the relationship between the agreements (perhaps even reference that the credit decision with respect to any subsequent agreement is based upon the agreed right of set-off in the earlier agreements);

ELIGIBLE FINANCIAL CONTRACTS

Another recent amendment to the CCAA introduced the concept of eligible financial contracts in Section 11.1.

Section 11.1(1) includes a definition for eligible financial contracts as including various types of agreements including swap agreements, derivative agreements, forward rate agreements and (in subsection (h) “a spot, future, forward or other commodity contract”).

Section 11.1(2) provides that no CCAA Order may stay or restrain the exercise of any right to terminate, amend or claim any accelerated payment under an eligible financial contract. Traditionally, CCAA Orders would require third parties to continue supplying or purchasing under agreements with a CCAA debtor company notwithstanding historic defaults or express provision in the sales / purchase agreement excusing performance in the event of the insolvency of the debtor so long as the debtor remained current for post-CCAA obligations. A debtor corporation enjoying the stay of all proceedings against it under the CCAA would often then terminate its third party agreements that were out of the money while requiring the performance of all contracts where the debtor enjoyed advantageous market pricing. Further, the debtor corporation could control the potential timing for repudiation of an agreement (often exercised as Blue Range did in conjunction with the prevailing practice of settling accounts on the 25th day of month following delivery).

In the Blue Range case, Mr. Justice LoVecchio concluded that pure financial agreements (such as ISDA agreements) were eligible financial contracts while commodity contracts, including the actual delivery of gas (such as Supply Agreements under a Master Agreement) were not eligible financial contracts.

Various gas marketers that had various long term purchase agreements with Blue Range under standard Master Purchase Agreements appealed the decision of Mr. Justice LoVecchio to the Alberta Court of Appeal insofar as it related to sales or purchase agreements that involved an actual supply of gas. The marketers provided evidence to the Court that their practice was to maintain a “closed” book by either re-selling the gas purchased from Blue Range or by using a variety of financial tools available to a trader, including swap or derivative agreements.

In the enclosed decision (Attachment 3), you will note that the Alberta Court of Appeal overturned Justice LoVecchio’s decision after making a thorough review of the gas marketing industry. As a result, the Blue Range gas sales / purchase agreements were found to be eligible financial contracts that provided the purchasing marketers with enhanced rights. Most significantly, as noted above, the CCAA stay of proceedings would not be effective as against those marketers to prevent them from exercising any rights of termination or acceleration that may have been negotiated into and included in the terms of their Master Agreements. While the Master Agreements had previously been terminated in the Blue Range matter (notably at the discretion and upon the timing chosen by the debtor, Blue Range) the appeal decision provides authority that third party marketers who negotiate acceleration or termination rights into their Master Agreements can maintain control over the potential termination of those agreements even in the event of a CCAA restructuring. (Virtually identical provisions are contained in the *Bankruptcy and Insolvency Act* with respect to a BIA proposal).

ELIGIBLE FINANCIAL CONTRACTS RECOMMENDATIONS

Based upon this recent decision, we would generally recommend as follows:

- (a) marketers should note in their Master Agreement that the gas being purchased or delivered is a portion of that marketers portfolio that may include swap, derivative or other financial instruments;
- (b) consideration should be given to expressly noting in the Master Agreement that the parties acknowledge and agree that the agreement is an eligible financial contract within the definition of the CCAA;
- (c) the marketer should attempt to negotiate and expressly include rights to accelerate, amend or terminate the Master Agreement upon a default of the other party, which default might be negotiated to include the insolvency or initiation of formal insolvency proceedings by the other party to the agreement.

COMPARABLE UNITED STATES BANKRUPTCY CODE PROVISIONS

Enclosed as Attachment 4 is a memoranda prepared by Joshua T. Blacker of our offices setting out the comparable *United States Bankruptcy Code* provisions to the relevant CCAA provisions discussed above.

It is significant to note that the *United States Bankruptcy Code* contains similar but not identical concepts concerning set-off and eligible financial contracts.

Our review could not identify any reported American decision concerning the comparable eligible financial contract provision. As such, the Alberta Court of Appeal decision may be of some relevance for consideration by any American jurisdiction considering the corresponding *Bankruptcy Code* provisions.

CONCLUSION

It is not anticipated that either Blue Range decision of the Court of Appeal will be further appealed to the Supreme Court of Canada. As such, these decisions represent the law in the Province of Alberta and would likely be a very persuasive authority in the other provinces of Canada. It remains to be seen, however, whether producers or other creditors will attempt to limit the effect of these Court of Appeal decisions by attempting to distinguish them on the facts of any future case. Further, some criticisms and concerns have been raised with respect to these appeal decisions arguing that they will, in conjunction, restrict a producer's or marketer's ability to successfully restructure under the CCAA. While this result is uncertain, it does appear certain that the effect of these decisions is to transfer some rights and discretions in a restructuring from the debtor company to its third party contractual counterparts where rights of set-off, acceleration, termination or amendment have been properly negotiated and included in the governing master agreements.

Of course, all of the foregoing is general in nature and any concerns that you have with respect to drafting appropriate forms of agreement or enforcement of those agreements should be considered on a case by case basis by you and your counsel.

ATTACHMENTS

1. *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended
2. Alberta Court of Appeal decision Docket Nos. 99-18395 and 99-18397 (set-off)
3. Alberta Court of Appeal decision Docket Nos. 99-18410, 99-18411 and 99-18418 (eligible financial contracts)
4. Macleod Dixon memoranda dated September 19, 2000 (*United States Bankruptcy Code* concordance)