

focus

on Financial Services



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DOWN UNDER DECISION

A decision of the New South Wales Supreme Court is causing some consternation among derivatives lawyers, not only in Australia but internationally as well. **The commercial effect of *Enron Australia v. TXU* could be significant.**

In *Enron*, the parties had entered into numerous electricity “swap” contracts under an ISDA Master Agreement by which one party agreed to pay a fixed rate, and the other a floating rate (based on the spot price of electricity), for the notional purchase of electricity to be delivered in the future. Prior to Enron’s liquidation, Enron and TXU netted their obligations and settled the amounts due under the various swap contracts on a weekly basis in accordance with the ISDA Master provisions.

The ISDA Master provides that the obligation by a party to make a payment is subject to the conditions that no Event of Default (actual or potential) or Early Termination Date shall have occurred or be designated. Enron’s voluntary liquidation constituted an Event of Default. Pursuant to the ISDA Master, the non-defaulting party (TXU in this case) had the right, but not the obligation, to designate an Early Termination Date. TXU chose not to exercise that right, but as a result of the Event of Default, it was able to suspend any further payments or deliveries otherwise due under the Agreement.

At the time of Enron’s default, TXU was “out of the money” to the extent of \$3.3 million. Not surprisingly, Enron’s liquidator sought to

disclaim the Agreement such that Enron’s “in the money” position would be realized at once, rather than at the expiry of the last swap contract. The court disagreed, refusing to interfere with TXU’s substantive rights under the Agreement, or to bestow substantive rights on Enron where they did not otherwise exist.

The effect of the court’s ruling is that, while TXU and Enron will continue to net their obligations in accordance with the Agreement, they will not have to “settle up” until the earlier of TXU designating an Early Termination Date, and the expiry of all outstanding swap contracts under the Agreement. At that time, depending on intervening fluctuations in the price of electricity, TXU may or may not owe Enron anything.

If a similar situation were to arise in Canada, it is likely that a Canadian court would come to the same conclusion as the New South Wales Supreme Court did in *Enron*. What this will mean for other creditors of derivative participants who would like reassurance on the access to assets, for financial institutions subject to capital adequacy regulation predicated on enforceable netting arrangements, and for the derivatives market in general, remains to be seen.

For further information on this case and its implications, please contact **Russel Kowalyk** of our Toronto office at (416) 862-3478, **Tom Pepevnak** of our Calgary office at (403) 268-7198 or **Jennifer Dezell** of our Vancouver office at (604) 433-7146.

COALBED CONUNDRUM

As one of Canada's leading undeveloped energy resources, coalbed methane (CBM) will likely play an important role in Canada's energy future. Canada produces about 6.3 trillion cubic feet of natural gas annually, and exports about 3.3 trillion cubic feet to the U.S. Researchers estimate that as much as 19.5 trillion cubic feet of CBM may be recoverable from the Western Canadian Sedimentary Basin.

CBM is natural gas which is embedded in (the industry uses the term "adsorbed to") coal molecules, rather than contained in a conventional reservoir. In Alberta and Saskatchewan, mineral rights are sometimes owned privately (called "freehold lands"), and in these cases the coal owner and the natural gas owner are frequently different entities (these lands are called "split title lands"). Accordingly, it is unclear whether the rights to the CBM are owned by the owner of the coal, or the owner of the natural gas. Many borrowers may have leases from the owner of the natural gas rights only and not from owners of the coal.

Legislatures have recently attempted to address the uncertainty regarding ownership of CBM posed by split title lands. In 2003, British Columbia chose to legislate that the natural gas owner has the right to the CBM. However, **in Alberta and Saskatchewan, there is no equivalent legislation respecting privately owned land, and the entitlement to the CBM remains unresolved as between the owner of the gas and the owner of the coal.**

This uncertainty poses a risk for lenders when contemplating the financing of CBM exploration and development. If the uncertainty regarding ownership of the CBM is resolved in favour of the coal owner (either by the courts, or by legislation) leases from the natural gas owner to explore for CBM would be worthless. **There is accordingly some title risk associated with collateralizing CBM until the issue is finally resolved.**

If you would like to discuss the issues surrounding coalbed methane, please contact **Miles Pittman** of our Calgary office at (403) 268-6313.

LENDERS BEWARE OF NOTICE REQUIREMENTS IN INSURANCE POLICIES!

In a recent decision, the Ontario Court of Appeal said that **an insurance company properly denied coverage to a lender when the lender failed to provide the notice** required under the mortgage clause of the policy.

The lender held mortgages on a home that had been destroyed by fire. At the time of the fire, the borrower had defaulted under both mortgages. The lender had commenced foreclosure proceedings and retained a company to inspect the property on a weekly basis. The property was vacated permanently by the borrower several months before the fire.

When the lender claimed under the insurance policy, the insurer denied payment. The policy contained an exclusion clause for loss or damage

occurring after the home had been vacated for more than 30 consecutive days. The mortgage clause in the policy required that the mortgagee notify the insurer (if known) of any vacancy or non-occupancy extending beyond thirty consecutive days. It was specifically stated in the mortgage clause that the terms of the mortgage clause "supersede any policy provisions in conflict therewith, but only to the interest of the mortgagee."

The lower court judge said that the vacancy exclusion in the policy was inconsistent with the terms of the mortgage clause and could not be applied against the lender. The Court of Appeal agreed, but went a step further to change the result. The mortgage clause created a contract between the lender and the insurer. The motion judge correctly said that the vacancy exclusion did not apply to the lender. But after the borrower vacated the property, the continued vacancy and the effective possession and control of the property by the lender were within the knowledge and control of the lender and materially increased the risk of the insurance company. **When the lender failed to give the vacancy notice required by the mortgage clause, the lender voided the contract with the insurance company.** The lender was not entitled to collect under the policy.

If you would like to discuss this case, please contact **Anita Joshi** of our Toronto office at (416) 863-4590.

WHO AND WHAT IS NEW AT FMC?

Brian Tobin recently rejoined FMC as a Senior Business Advisor. Brian has a prominent political history spanning over 20 years and served as federal Minister of Industry from 2000 to 2002. Brian is returning to FMC after having recently served as CEO of MI Developments, part of the Magna Group of companies.

Brian Carr of our Toronto Tax Group was recently elected as Chair of the Canadian Tax Foundation. Brian is a senior member of our National Tax Practice Group and has been a partner at FMC for over 6 years. He has written and lectured extensively and has participated in many committees on tax matters.

WHAT WE'VE BEEN DOING IN FINANCIAL SERVICES

Here are just some of the recent transactions on which our various offices across Canada have worked:

- Acting as counsel to the lending syndicate in connection with financing provided for the establishment of an income trust, and the concurrent purchase of a related business by the income trust.
- Advising a financial institution as to various aspects of an intended merger with another financial institution.
- Advising a client on certain aspects of operating a money transfer business in Canada.