

INSOLVENCY REFORM AND THE ASSET-BASED LENDER

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INTRODUCTION

The most significant legal event affecting asset-based lenders in recent years is the somewhat surprising enactment of legislation materially amending Canada's insolvency laws. In November of 2005, Parliament and the Senate passed Bill C-55 that contained significant, detailed amendments to the *Bankruptcy and Insolvency Act* (BIA) and the *Companies' Creditors Arrangement Act* (CCAA). The process to enact Bill C-55 was rushed. As a result, as currently drafted Bill C-55 gives rise to a significant number of issues both of a substantive and of a drafting nature.

The Senate Standing Committee on Banking, Trade and Commerce (Senate Committee) did not have an opportunity to conduct a comprehensive review of Bill C-55 due to the hurry to pass it prior to the January 23, 2006 federal election. The Senate Committee extracted an assurance from the federal government that Bill C-55 would not be proclaimed in force before June 30, 2006 at the earliest. It is expected that this will provide the time necessary for rectifying legislation to be passed to correct deficiencies recognized by the Senate Committee in Bill C-55 before it is proclaimed.

When Bill C-55 is proclaimed in force, there are a number of aspects of the legislation that will impact asset-based lenders. The purpose of this article is to draw the attention of asset-based lenders to elements of Bill C-55 of particular interest to them, rather than to provide a general overview of the legislation.

For example, in light of Bill C-55 asset-based lenders will: (1) reassess what reserves are appropriate with respect to employee and 30-day goods claims when calculating a borrower's borrowing base; (2) reassess reporting requirements with respect to employee claims; (3) consider addressing new issues with respect to employee claims in intercreditor agreements; and (4) assess the impact of the increased risks to secured lenders in reorganization proceedings.

EMPLOYEE CLAIMS

Wage and Vacation Pay Lien

Bill C-55 provides an employee of a bankrupt employer, or of an employer in receivership, with a super-priority charge on the employer's "current assets" for wages and vacation pay (but not for severance or termination pay). This charge will secure unpaid wages and vacation pay for the 6-month period prior to bankruptcy or receivership to a maximum of \$2000 (plus up to \$1000 for disbursements by "travelling salespersons"). In receivership (but

not in bankruptcy), the super-priority charge ranks ahead of government claims for unpaid source deductions relating to income tax, employment insurance and government pension plans. The super-priority charge ranks ahead of all other claims except unpaid supplier rights.

Asset-based lenders lending on the security of operating assets (inventory and receivables) will have to decide if the new statutory priority for wage and vacation pay arrears should have any impact on borrowing base calculations. At present in bankruptcy wages and vacation pay are subordinate in priority to secured creditors' claims. However, in practice it is usual to pay payroll arrears for a variety of practical reasons, including the need to secure employee co-operation and because of the personal liabilities of directors. Current practice with respect to vacation pay is more variable.

Pension Contributions Lien

Bill C-55 also grants a super-priority charge in bankruptcies and receiverships for outstanding current service pension plan contributions, ranking behind the employee remuneration super-priority but otherwise with the same priority as is accorded to that lien. The pension contribution super-priority extends to all assets, not just current assets.

In essence, the charge will secure (1) amounts deducted as pension contributions from employee wages prior to a bankruptcy or receivership but not contributed to the pension fund, and (2) amounts required to be contributed by the employer either to a defined contribution pension plan, or to a defined benefit pension plan for current service. The super-priority does not extend to unfunded deficits arising upon wind-up of a defined benefit plan or to catch-up or special payments. Unlike the wage lien, there is no monetary cap on the amounts secured by the pension contribution lien.

In practice there are rarely significant arrears of contribution arrears for current service because of the personal liabilities that arise upon a failure to remit. However, the existence of the lien will enhance the importance of effective reporting and monitoring of pension contributions by the borrower, as well as other employee obligations such as vacation pay.

Technical Issues

There are numerous detailed technical problems with the legislative provisions creating the super-priority charges. Examples include:

1. it may be that if there is both a bankruptcy and a receivership that there are two wage charges securing up to \$4,000 per employee, instead of one charge securing up to \$2,000;
2. it is unclear whether or not if an employee is owed more than \$2,000 that voluntary payments made by a receiver or trustee are credited against the \$2,000 limit on the wage charge. This arises because as part of Bill C-55, the federal government is providing a form of wage insurance to employees of insolvent companies and the federal government will receive an automatic assignment of the wage lien upon any payment to any employee;

3. it appears that the wage lien attaches to the proceeds of a sale of fixed assets because an accounting definition “current assets” was used in Bill C-55 that includes cash and cash equivalents. This will create mechanical problems when loans are being repaid from the voluntary sale of fixed assets, and may discourage mortgages, secured term lenders and equipment lessors from allowing troubled borrowers to self-liquidate;
4. the legislation does not allocate the burden of the charges if they affect more than one secured creditor. Intercreditor agreements should be revised to address this issue; and,
5. receivers and trustees (whether acting for an operating lender or a term lender) are compelled to incur compliance costs with respect to the government wage insurance plan which will not be reimbursed by the government. The recovery of these costs appears to rank junior to the super-priority liens but in priority to other secured claims (including against fixed assets). If there is more than one receiver (or a trustee in bankruptcy and one or more receivers) there is no mechanic for allocating the administrative burden of compliance or the costs of compliance. Again this issue should be addressed in intercreditor agreements.

THIRTY-DAY GOODS

Currently under the BIA, an unpaid supplier of goods that fit within specified parameters (eg, goods that are identifiable and have not been resold) may be entitled to repossess those goods. The right arises if within 30 days of delivery of the goods, the purchaser becomes bankrupt or subject to receivership and the supplier makes a written demand for their return.

In the process leading up to Bill C-55, there was substantial lobbying for changes that would enhance the rights of unpaid suppliers. Bill C-55 slightly modifies the 30-day provisions. It makes a mechanical change that will make it easier for unpaid suppliers to claim the lien, by changing the period within which the unpaid supplier’s demand must be delivered to 15 days from the commencement of the bankruptcy or receivership. It also gives the Court the power to extend that 15-day period.

Bill C-55 contains other technical amendments that may marginally enhance 30-day good claims. For example, it restricts the use of “interim” receivers (whose appointment does not necessarily trigger 30-day goods claims).

COURT-ORDERED LIENS

Debtor-in-Possession (DIP) Financing

In recent years, notwithstanding the absence of specific statutory authority, Courts have granted orders authorizing borrowing and the granting of security by debtors subject to CCAA proceedings. Bill C-55 now codifies that practice.

The method of codification will arguably make it easier for the borrower to obtain DIP financing on a priming basis without the consent of the existing secured lenders, and therefore increases the risk to asset-based lenders in hostile situations. For example, Bill C-55 provides that:

1. whereas Canadian DIP financing developed primarily in CCAA proceedings, Bill C-55 will extend that benefit by expressly permitting a debtor making a proposal under the BIA to obtain DIP financing. Proposals typically involve smaller insolvencies so DIP transactions are likely to become more common in smaller cases;
2. the debtor can obtain an order authorizing a priming DIP for an initial 30-day period without notice to the secured creditor being primed. Only if the order covers a period greater than 30 days must notice seeking the order be given to the secured creditor; and,
3. Bill C-55 sets out a number of factors that a court must take into account in determining whether to authorize DIP financing including prejudice to creditors generally. There is no provision that requires that there be adequate protection for, or no material prejudice to, a secured creditor being primed by the DIP, or that this is even a relevant factor to be considered.

Other Court-Ordered Liens

Bill C-55 also expressly authorizes a Court in both BIA proposals and CCAA proceedings to grant, in priority to the charges held by secured creditors, various additional charges including:

1. a charge to secure payment of fees and costs (including legal costs) incurred by trustees, receivers or CCAA monitors, as well as professional advisors (which would include lawyers and financial advisors) to the debtor;
2. a charge to secure the costs of “interested” parties (eg, creditors’ committees and their advisors) if satisfied that the incurring of those costs is “necessary for the effective participation of the interested party” in the relevant BIA proposal or CCAA proceedings; and
3. if in the Court’s opinion adequate insurance is not available at reasonable cost, a charge on the debtor’s assets in favour of directors and officers to indemnify them against obligations or liabilities that they incur post-filing in acting as a director or officer of a debtor involved in a proposal or CCAA proceedings.

The effect of codifying the DIP provisions and expressly authorizing the additional charges could be to make it very difficult to oppose DIP financing and the administrative costs being financed in priority to existing secured creditors’ rights. This will give secured creditors less negotiating leverage in the run-up to restructuring filings, and during restructuring proceedings.

STATUTORY POWER OF SALE

Bill C-55 amends the BIA and the CCAA to expressly empower the Court to authorize an insolvent person to sell assets outside the ordinary course of business with Court

authorization. This could involve the debtor's entire business. The provisions contain a number of factors to be considered by the Court when deciding how to exercise its discretion. However, the fact that the sale involves the collateral of a secured creditor for proceeds that will be insufficient to pay out the secured creditor is not one of those factors. As a result, the provisions increase the risk of a secured lender losing control of its collateral in a restructuring proceeding.

SUCCESSOR EMPLOYERS

Recent case law has heightened concerns about trustees and receivers becoming personally liable as successor employers for such obligations as wages, vacation pay, severance and termination pay, and pension claims. The liability can arise by virtue of the insolvency administrator taking possession of the assets of a business and operating it in the hope of selling it on a going concern basis, only to fail with the result that the assets are liquidated.

In those circumstances it may be claimed that the insolvency administrator became the employer by operation of law, and therefore be personally liable to the employees. Asset-based lenders are impacted by this personal liability risk either because of indemnities or because personal claims against the insolvency administrator are paid out of the proceeds of realization in priority to the distributions to the secured creditors.

Bill C-55 attempts to address the issue of personal liability for receivers and trustees by providing that a receiver or trustee carrying on a debtor's business or continuing the employment of the debtor's employees, will not by virtue of that fact be personally liable in respect of a claim if it relates to a debt or liability, present or future, to which the debtor is subject on the day on which the trustee or receiver is appointed. The intent of this provision is that the receiver not be liable, for example, for any severance or termination pay relating to periods of employment prior to the appointment of the receiver. However, it may be argued that the drafting of Bill C-55 is inadequate to actually achieve that result.

EXECUTORY CONTRACTS

Bill C-55 introduces a statutory regime whereby an insolvent debtor may sell or disclaim executory contracts. The provisions are rudimentary as compared to the provisions of U.S. Bankruptcy law. However, there may be circumstances where an asset-based lender can indirectly benefit from them. For example, these provisions may enable a business that depends on ongoing contracts to be sold without the consent of the counterparties to the contracts. While the counterparties to the contracts will have the right to challenge the sale in Court, that may in practice prove to be ineffective.

CONCLUSION

There are numerous detailed provisions of Bill C-55 that will affect insolvency proceedings in Canada. A full discussion of these changes is beyond the scope of this paper. Many of the changes will be beneficial by facilitating going concern solutions and encouraging greater consistency in proceedings across the country. However, to some degree the rights of asset based lenders could be impaired. It is hoped that beneficial amendments will be made to the legislation before it is proclaimed in force.