An Overview of Canadian Insolvency Law and Cross-Border Considerations

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Introduction

Constitutional Background

Canada has a federal system of government. Legislative jurisdiction is divided between the federal legislature (Parliament) and the legislatures of Canada's 10 provinces. Bankruptcy and insolvency is a matter of federal jurisdiction. Accordingly, in principle, bankruptcy and insolvency law and practise should be uniform across Canada.

However, property and civil rights, which include the areas of real and personal property and the creation and realization of security, are matters of provincial jurisdiction and differ from province to province. The juxtaposition of these provincial laws and federal bankruptcy and insolvency laws gives rise to some provincial differences.

Moreover, the courts having jurisdiction in bankruptcy and insolvency matters across Canada are provincially administered courts of general jurisdiction that are staffed by federally appointed judges. Judges exercise general jurisdiction within a province; there are no "bankruptcy judges," although the courts of some of the provinces have organized themselves in such a way as to promote specialization of judges. There is some variance from province to province in the way the courts function.

Statutory Framework

Canada has two main federal statutes dealing with insolvency, the *Bankruptcy and Insolvency Act* (BIA) and the *Companies' Creditors Arrangement Act* (CCAA). The BIA deals both with full bankruptcy (analogous to Chapter 7 of the US *Bankruptcy Code*, but with many differences) and the reorganization of corporations and individuals.

The CCAA deals with the reorganization of corporations or corporate groups having aggregate liabilities of at least $5 million. This statute is Canada's closest equivalent to Chapter 11 of the US *Bankruptcy Code*, but there are great differences in the laws, the practises and, to some extent, the policies of the laws.

The reorganization system provided by the BIA is rather rigid. It provides a relatively quick, simple and inexpensive system of reorganization, but it lacks the flexibility usually required for the reorganization of larger enterprises. Typically, it is used for the reorganization of small and medium-sized businesses. Reorganizations of large entities are usually conducted through the CCAA process.

Both the BIA and the CCAA are the subject of significant recent amendment, further to an act (the *Reform Act*) passed in the dying days of the last Parliament but whose proclamation into force has been delayed until at least June 30, 2006 to allow for a possibility of review and amendment. If the *Reform Act* is proclaimed into force as is, there will be a greater degree of consistency between the BIA and CCAA, and much of what was previously a judicial order-driven process under the CCAA will be codified.

The Canadian Psyche: Differences Between Canadian and US Law and Practise

The differences between Canadian and US law and practises cannot be understood merely by way of a comparison of the differences in the respective statutes. There are also significant systemic and cultural differences.

The Canadian process tends to be less litigious. Litigation plays a much smaller role in Canada than is the case in the US. Negotiation among stakeholders plays a major role and this is generally strongly encouraged by the courts.

There is no constitutional protection in Canada for property rights as there is in the US. This leads to differences of approaches in insolvency law in Canada and the US. For example, in Canada, there is no clearly defined concept similar to the US "adequate protection" concept.

Canada has a system of federally licensed bankruptcy trustees. Trustees are professionals who are usually chartered accountants (the Canadian equivalent of CPAs). The major accounting firms all have bankruptcy and restructuring departments headed by bankruptcy trustees. Licensed trustees serve as trustees in full bankruptcy proceedings and as monitors in reorganization proceedings. They are officers of the court and the courts typically place a great deal of reliance on their views and recommendations.

The Canadian system of reorganization, especially under the CCAA, is characterized by a great deal of judicial flexibil-

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ity. Even under the *Reform Act*, the rules will be much more simple and less technical than is the case under the US *Bankruptcy Code*.

Typically, bankruptcies and reorganizations in Canada are conducted, and concluded, much more expediently, and with considerably less expense, than is the case under the US *Bankruptcy Code*.

Before the enactment of the *Reform Act*, Canadian legislation did not distinguish between "shareholder-related claims" and "ordinary creditor claims". This created the potential for serious injustice, and was seen as a systemic flaw. The *Reform Act* provides for deferred status for shareholder-related claims. In the light of this change, and the factors referred to above, Canada should be considered a very hospitable jurisdiction for instituting main proceedings in a cross-border context.

General Overview

The present outline is not intended as an exhaustive analysis of the Canadian insolvency system. It seeks only to summarize the salient features of the system and to provide a glimpse of the context and dynamics of the system and the comparative features of the Canadian and recently enacted US *Bankruptcy Code* regimes on cross-border insolvency proceedings.

Bankruptcy (Chapter 7 Equivalent)

The term "bankrupt" in Canada applies only to the situation where the debtor's assets have vested in a bankruptcy trustee for the purpose of liquidation. A reorganizing debtor is not referred to as "bankrupt" or as having gone into bankruptcy, although a debtor in the process of reorganiztion is sometimes referred to as being "under bankruptcy protection."

A debtor becomes bankrupt by either a voluntary assignment of his property to his creditors generally, a forced "receiving order" issued on the initiative of one or more creditors, or upon the failure of a BIA "proposal" to obtain creditor acceptance or court approval.

The assets are liquidated by the trustee under the supervision of a committee of creditors known as inspectors. If appropriate, the trustee conducts an investigation into the affairs of the debtor and institutes the appropriate recovery proceedings.

Reorganization Under the BIA

The BIA provides for a system of reorganization that is initiated by a debtor filing either a proposal or a notice of intention to file a proposal (NOI). Proposal is the term used in the BIA for a plan of compromise.

Under the changes to the BIA reorganization process provided by the *Reform Act*, a debtor will have more flexibility than was previously the case, thereby rendering the BIA process more akin to that under the CCAA.

The filing of a NOI brings with it an automatic stay of proceedings in favor of the debtor for an initial period of 30 days, which can be extended for successive renewals for periods not exceeding 45 days, with a statutory maximum stay period, preceding the filing of a proposal, of six months. The filing of a proposal also gives rise to an automatic stay.

A proposal must be filed during the stay period following the filing of a NOI, failing which the debtor becomes automatically bankrupt. If the creditors fail to accept the proposal, or if the accepted proposal is not approved by the court, the debtor is deemed to be bankrupt.

The BIA's reorganization regime in its current form contemplates little more than the compromise of debt. One of the most radical changes resulting from the proclamation into force of the *Reform Act* will be to broaden the scope of what can be accomplished under this regime. This ranges from permitting a debtor to disclaim a broad spectrum of executory contracts to facilitating debtor in possession financing (DIP) and other substantial debtor relief to date available only under the CCAA's reorganization system. While there will be greater consistency between the BIA and the CCAA regimes, it is likely that most major reorganizations will continue to be conducted under the CCAA.

Reorganization Under the CCAA

Introduction

The CCAA was enacted in the 1930s, at the time of the Great Depression, as a mechanism to provide relief for insolvent corporations. The statute fell out of use, and was almost totally ignored until about the early 1980s. Since that time, it has been used as the statute of choice for the reorganization of large insolvent corporations and corporate groups.

In its current form, the CCAA is a very short statute. It was somewhat modernized and extended by two sets of amendments in the 1990s. The *Reform Act* provides more rules and guidelines than has been the case, mainly through the codification of much of what has been a judicial order-driven process under the CCAA.

Restructuring under the CCAA is available only to corporations or groups of corporations having debts totalling at least $5 million.

The text of the CCAA provides very little enlightenment on how the system actually works. In practise, the courts, essentially through the exercise of their inherent jurisdiction, have greatly expanded the scope of the CCAA and have crafted what is, in effect, a customary regime of reorganization of large insolvent corporations. The *Reform Act* provides a codification of much of this customary regime. It is contemplated that even if the *Reform Act* is proclaimed into force as is, the CCAA will still provide significant scope for the exercise of judicial discretion and the crafting of creative solutions.

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The positions taken by courts on various aspects of reorganization under the CCAA vary greatly from province to province. This gives rise to a degree of forum shopping, which has been facilitated by a very flexible interpretation of the provisions of the CCAA dealing with geographical jurisdiction. In this regard, the courts of the province of Ontario are seen as being very efficient and receptive to the CCAA process and to the creative solutions proposed thereunder. Accordingly, many of the most important restructurings under the CCAA to date have taken place in Ontario without regard to where the "center of gravity" of the reorganizing corporation was located.

Certain Features of the CCAA

The following is a description of certain features of the practise, which have evolved under the CCAA and which are proposed to be codified, to varying extents, further to the *Reform Act*.

Stay of Proceedings

The CCAA in its current form provides little guidance as to the form or substance of the stay of proceedings, other than to provide limitations in certain closely defined areas. For example, the CCAA precludes an order for the obligatory extension of credit, an order preventing the closing out of a widely defined category of "eligible financial contracts," or an order precluding the drawing on a letter of credit. Under the *Reform Act*, prohibited renunciations will extend to collective agreements, financing agreements where the debtor is a borrower and, to a certain extent, a licensee's ability to continue using the debtor's intellectual property.

Stay orders under the CCAA are as complex as the statutory provisions of the CCAA concerning the stay are simple. Such orders typically give the debtor the right to renounce executory contracts, except those for which there is a statutory prohibition.

There is no necessity for a debtor to adopt executory contracts; they remain in force unless otherwise affected by an order.

CCAA stay orders sometimes extend to the relationships between third parties, and the broad reach of such orders will not diminish under the new regime of the *Reform Act*. For example, there have been instances wherein it has been ordered that fellow shopping-center tenants of a reorganizing retailer were prohibited from exercising recourses against their landlord, which would otherwise have been triggered by the debtor's renunciation of a lease in a shopping center.

As a result of the far-reaching scope of stay orders, the course of the reorganization is very often set, without significant creditor input, well before a plan is filed.

Debtor in Possession (DIP) Financing

The CCAA in its current form does not deal with DIP financing. The general principle in Canadian reorganization law (whether under the CCAA or the BIA) is that the corporation continues. No new "estate" is created by the filing of proceedings. The debtor remains subject to the same security interests as before the filing. Accordingly, for example, if the issue is not addressed in an order, an existing secured lending arrangement can continue.

The *Reform Act* provides the first statutory codification of courts' power to authorize DIP lending facilities and the related super-priority security charge in the CCAA, and extends it to BIA restructurings. The extent of the new security charge and DIP financing that may be authorized is intended to be a function of the debtor's cash needs over the first 30 days of a restructuring, subject to adjustment upon notice to affected secured creditors. Courts will be called upon to consider a number of criteria when deciding whether to permit DIP financing and authorize the super-priority charge.

Wage Earner Protection

Much of the impetus behind the *Reform Act* was related to a perceived need to improve the fate of current and former employees in insolvencies. To that end, the *Reform Act* provides employees, under both the BIA and the CCAA, a first-ranking super priority on "current assets" for wages and a super priority on all assets for certain current services pension contribution entitlements. Employees may also receive compensation from a newly created, government administered "wage earner protection program." Payments made under this program will be recoverable by the governmental authority through its subrogation to the employees' rights.

Corporate Governance and the Role of the Monitor

The *Reform Act* contemplates significant judicial input into corporate governance of restructuring debtors, including the power to remove directors and to provide indemnification of directors against certain post-filing personal liabilities. While the role of the monitor, as defined by the CCAA, is rather limited, it is extremely important in practise. Stay orders frequently create a substantially expanded role for the monitor, which can extend to the ability to approve contracts and transactions and to renounce other contracts. Monitors have assumed the role of the "eyes and ears of the court." They are usually, although not necessarily, licensed bankruptcy trustees.

The courts tend to be very closely guided by their views and reports. The result is that monitors have become a major factor in the reorganization process. This will not change under the *Reform Act's* amendments to the CCAA.

Creditors' Committees

The CCAA does not address creditors' committees and the *Reform Act* contains only an indirect facilitation of their role. CCAA proceedings are frequently conducted without any formal involvement of representatives of creditors, with

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the result that the first appearance of creditors as a group is at the meeting of creditors called upon to vote on the plan, whose direction has already been determined.

Occasionally, the court orders the formation of a creditors' committee to receive information and to interface with the debtor and/or monitor in the formulation of a plan. The *Reform Act* will provide for the possibility of creating a charge over the debtor's property in respect of certain expenses of "interested parties" in order to facilitate their effective participation in proceedings, which could result in more active involvement of creditors' committees.

Claims Processes

The CCAA does not address the process of the filing and administration of claims. The process is usually set through an order of the court. As indicated above, the *Reform Act* provides, for the first time, for the deferment of shareholder-related claims.

Sales of Assets and Vesting Orders

In bankruptcies, sales of assets are subject to the approval of a creditors' committee, known as inspectors. Sales usually take place pursuant to a call for public tender or other mechanism designed to obtain the best price. It is only by exception that the court becomes involved in the process.

Assets are frequently sold as part of the process of reorganization under the BIA or the CCAA. The *Reform Act* requires that any sales made out of the ordinary course of business be approved by the court, for which a number of criteria, generally relating to commercial reasonableness, are set forth. The criteria are more stringent for sales to non-arms' length parties.

Cross-border Proceedings

Canada was the second country, after the United States, to develop a modern reorganization culture following the adoption in 1979 of the modern form of *Chapter 11* of the US *Bankruptcy Code*. As a result, there is now a 25-year history of experience with reorganizations that cross over the US/Canada border.

In 2005, the United States enacted a new *Chapter 15* of the US *Bankruptcy Code* that largely adopts the United Nations Commission on International Trade Law (UNCITRAL) model law for recognition of foreign insolvency proceedings. The *Reform Act* will make similar amendments to the BIA and CCAA.

The purpose of the UNCITRAL model law was to encourage greater cooperation between judicial systems with respect to multinational insolvencies. Cooperation already exists across the US/Canada border. It is therefore unclear whether the statutory reforms in the United States and Canada will have any material impact on US/Canada cross-border reorganizations.

However, there are two potential areas of impact. The first is with respect to corporate groups. At present the general practise is to file proceedings in respect of a subsidiary in the country where the subsidiary is based, rather than to file the subsidiary together with the parent in the country where the parent is based. That practise may be challenged under the new laws. In addition, historically there has been the flexibility to have a full CCAA proceeding under Canadian law, and a full *Chapter 11* proceeding under US law, for the same debtor. It is unclear whether the recent statutory amendments will eliminate that flexibility.

Concluding Remarks

A number of technical concerns have been identified by insolvency practitioners in Canada and as a result the Canadian government has agreed to delay the proclamation into force of the *Reform Act* until June 30, 2006. This raises the possibility that the provisions of the Reform Act may themselves be the subject of amendment. Overall, however, the major policy shifts embedded in the *Reform Act* and its codification of existing Canadian restructuring and bankruptcy practise will likely be retained. It is not anticipated that the *Reform Act*, if enacted, will dramatically change Canadian insolvency practise.

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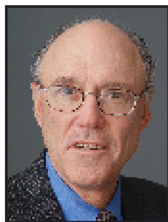

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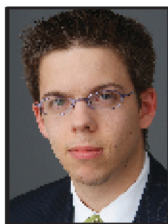

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