

# Reform Restructuring Legislation in Canada: Evolution or Revolution?

BY ÉRIC VALLIÈRES, PARTNER, & NICK SCHEIB, ASSOCIATE, MCMILLAN BINCH MENDELSON LLP

Canada's Parliament last November passed the "Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act, and to make consequential amendments to other acts." If proclaimed into force as is on June 30, 2006,<sup>1</sup> the Reform Act will effect fundamental legislative changes to the main Canadian restructuring statutes.

As things now stand, much of the law applicable to larger restructurings has been developed incrementally on a case-by-case basis by the Canadian bankruptcy courts. Asserting a broad "inherent jurisdiction" and loosely basing themselves on the sparsely drafted Depression-era Companies Creditors' Arrangements Act (CCA), Canadian bankruptcy courts have developed since the early 1990s a comprehensive, albeit fluid, body of rules, with a view to addressing the ever-evolving needs of distressed debtors and their stakeholders.

These rules provide for sophisticated debtor-in-possession (DIP) financings, vesting orders, claims processes, and ad hoc bidding processes. The approach of the Canadian bankruptcy courts has often been praised for its flexibility and responsiveness to the needs of the business community but criticized for its lack of predictability. The absence of clear statutory guidance has led to a lack of uniformity among the Canadian provinces in the application of these judicially formulated rules. Major debtors have been more or less free to choose their province of filing, a situation that has created a degree of uncertainty in the market.

The flexible CCA approach applies only to larger restructurings, those involving more than \$5 million (CAD) in debt. Restructurings of lesser magnitude are conducted under another Canadian statute, the Bankruptcy and Insolvency Act (BIA), which lacks the flexibility inherent to the CCA. As a result, the solutions developed by the Canadian bankruptcy courts under the CCA are generally not applicable in BIA proceedings. Hence, for example, it is generally accepted that DIP financings are not approved by courts in BIA-based restructurings.

One of the main purposes of the Reform Act is to bring more consistency to the Canadian restructuring system by codifying some of the solutions developed by the courts and making them accessible in smaller restructurings. The Reform Act also proposes a number of major changes and innovations that mark a significant evolution from existing law and practice.

In general, the legislative changes brought about by the Reform Act should not impair the traditional flexibility of Canada's restructuring legislation significantly, nor should they materially alter the Canadian pragmatic approach, which tends to favor negotiation among stakeholders over costly litigation.

## Key Measures

The most notable aspects of the reform are as follows:

**Special Restructuring Priority Charges.** Even though DIP financing has been an important feature of CCA-based restructuring practice for a number of years, it had no clear statutory basis. The Reform Act provides the first statutory codification of this facility in the CCA and extends it to BIA restructurings.

Canadian bankruptcy courts also will be empowered to grant fresh security over a debtor's assets to DIP lenders under both BIA and CCA restructurings. Consistent with current CCA practice, courts can determine that the DIP security trumps the priorities accorded to existing security interests. This may prove to be a cause of concern to many.

The extent of the new security 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 upward adjustment upon notice to affected secured creditors. Under the new regime proposed by the Reform Act, Canadian bankruptcy courts would be required to consider the following criteria when deciding whether to permit DIP financing and to authorize the related super-priority charge:

- The length of time that the debtor is likely to need to be subjected to creditor protection proceedings
- The nature of the governance of the business and financial affairs of the debtor
- Whether management has the confidence of the debtor's major creditors
- Whether the proposed financing will enhance the debtor's prospects as a going concern if and when it resurfaces from creditor protection
- The nature and value of the debtor's assets
- Whether any creditor will be materially prejudiced by the debtor's ongoing operations
- Other considerations appropriate to the circumstances

In addition to DIP financing and the directors' special charge discussed later in this article, the Reform Act also makes room for other special restructuring priority charges. For example, a court may order a special charge for a debtor's costs for financial and legal professionals and other experts. The court also may authorize security for the costs of court-appointed officials, such as trustees, interim receivers, and receiver-managers, as well as for those of any "interested party," to the extent that it would be necessary for their effective participation in the proceedings.

As is the case with the other new priority charges available under the Reform Act, courts are empowered to determine the relative rank of these various charges — both among each other and vis-à-vis existing, pre-stay security interests—and thereby establish an ad hoc, yet binding, priority scheme with respect to a debtor's assets.

#### **Directors' Risks, Liabilities, Protections.**

The Reform Act allows for significant judicial input into corporate governance in restructurings. Most strikingly, the amended BIA and CCAA would give judges power and discretion to remove and replace existing directors based on a prospective consideration of whether they are “likely to unreasonably impair” a debtor's reorganization.

In a codification of the recent practice of fostering the continued participation of vital corporate management in initial stay orders — akin to first-day order in U.S. Bankruptcy Court — the Reform Act provides for the possibility of meaningful indemnification of directors and officers, secured by the assets of the debtor corporation, against post-stay-period personal liabilities.

**Asset Sales, Vesting Orders.** One notable change introduced by the Reform Act under both the BIA and the CCAA is that Canadian bankruptcy courts will be called upon to approve any sale of a debtor's assets made outside the ordinary course of its business. Under the CCAA, past practice has been inconsistent in this regard. Under the BIA, the absence of a court review requirement has sometimes led to abuses.

Criteria for issuance of a sale order include an assessment of the sale process followed, the consideration arising from it, and the effect of the sale on the interests of stakeholders of the debtor corporation. Added protection of these interests is afforded if a purchaser is not dealing at arm's length. The new law requires that a restructuring debtor or bankruptcy trustee have attempted to engage a sale process involving arm's length parties.

Once it is satisfied with the process, a court may issue a vesting order directing that a debtor's or bankrupt's secured creditors only have a security interest in the proceeds of the sale, with the successful purchaser taking the assets free and clear of any creditor interests. The new provision would standardize the regime governing vesting orders across the country. In some provinces, courts had been reluctant to impose such vesting orders, absent the consent of the affected security holders.

**Executory Contracts.** The Reform Act renders largely consistent the types of executory contracts that can be disclaimed while a debtor is under BIA or CCAA protection. These specifically exclude “eligible financial contracts” and collective agreements. In the past, leases of commercial real estate were the only executory contracts subject to disclaimer under the BIA.

**Labor, Employee Issues.** Much of the impetus behind the Reform Act related to a perceived need to improve the fate of current and former employees in insolvencies. To that end, the Reform Act alters the existing rank afforded claims by employees in bankruptcy situations.

Employee claims for unpaid wages and vacation pay up to a maximum of \$2,000 earned up to six months prior to a bankruptcy will benefit from a first-ranking charge over the “current assets” of a debtor. Employees also may be entitled to compensation from a newly created, government-administered Wage Earner Protection Program. The immediate repayment of such claims up to \$2,000 must be provided for in any BIA proposal or CCAA plan of restructuring.

The amended BIA and CCAA also specify that current service pension shortfalls must be remedied in any restructuring plan, and claims based on them are accorded a new charge with super-priority status in a bankruptcy. This charge extends to all of a debtor's assets, rather than just to the “current assets” called into account with respect to employee wage claims.<sup>2</sup>

#### **What's Next?**

The codification of criteria for the nature and extent of DIP lending and its related super-priority charges likely will change the dynamics of future corporate restructuring in Canada. To date, establishing the parameters of how much security can be granted to a DIP lender in preference to that of existing lenders has been the source of uncertainty and turmoil in the supercharged atmosphere of high-profile restructurings. The Reform Act may serve to simplify this situation.

Directors acting in good faith should see the burden of their ongoing participation in the management of distressed lenders alleviated by the Reform Act's protections. Conversely, the changes should serve to thwart those seeking to leverage their fiduciary position on corporate boards and access to control for personal gain.

Insolvency practitioners in Canada have identified a number of technical worries and as a result, the Canadian government has agreed to delay the proclamation into force of

the Reform Act until June 30. This raises the possibility that the Reform Act may be amended before it goes into effect. Overall, however, the major policy shifts embedded in the act and its codification of existing Canadian restructuring and bankruptcy practice likely will be retained.

The codification provided by the Reform Act should serve to strike a good balance between a greater degree of predictability and uniformity, and the traditional flexibility that has fostered the success and the reputation of Canadian restructuring laws over the past decades.

<sup>1</sup> The expedited passage of Reform Act during the final days of the last session of Parliament drew criticism from the industry and Canada's upper house of Parliament, the Senate. The deferral of its proclamation into force is ostensibly to permit its review and possible amendment. See “Flawed Canadian Insolvency Law Reform Enacted?” at [www.mcmillanbinch.com](http://www.mcmillanbinch.com).

<sup>2</sup> The new charge will not apply to solvency deficiencies resulting from the termination of a pension plan upon the bankruptcy of its sponsor per se, but rather to those current service contribution payments that were due but went unpaid prior to bankruptcy.

*Éric Vallières (top photo) is a partner and Nick Scheib (bottom photo) is an associate in McMillan Binch Mendelsohn's Corporate Restructuring and Insolvency Group. Vallières advises financial institutions, private equity funds, and institutional investors on business restructurings, as well as debt enforcement matters and in realization proceedings.*

*He also advises distressed businesses, insolvency accountants, and turnaround specialists in connection with debt restructuring matters, turnaround scenarios, and bankruptcy cases.*

*Scheib acts as counsel to stakeholders in restructuring and bankruptcy matters, including financial institutions, trade suppliers, trustees and receivers of bankrupts and restructuring companies, and corporate directors. He assisted Max Mendelsohn, a partner in the firm, in his role as one of three private sector advisors to Industry Canada in its preparation of the Reform Act.*



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