

insolvency and restructuring bulletin

September 2009

the impact of recent reforms to canadian insolvency legislation

On September 18, 2009, long-awaited amendments to the *Bankruptcy and Insolvency Act* ("BIA") and the *Companies' Creditors Arrangement Act* ("CCAA") take effect that will have a significant impact on commercial insolvencies in Canada. While many of these changes reflect existing practice and case law, some introduce more novel concepts not developed by courts, broadening what can be accomplished under the insolvency regime. This article comments on salient features of the new amendments.

Codification of Existing Practice

The amendments seek to harmonize the BIA and CCAA, codifying in both statutes many aspects of the judicially-driven reorganization process of the past 15 years. The result is a more integrated regime which will provide greater predictability, consistency, and transparency. Some of the codified areas include:

DIP Financing

There is now codification, in both the BIA and CCAA, of the Court's power to authorize debtor-in-possession ("DIP") lending facilities and a super-priority charge that secures the DIP facility.¹ The charge cannot secure obligations that existed prior to the order. The Court must consider the following factors when considering whether a DIP facility should be approved:

- (i) the period during which the debtor is expected to be subject to proceedings under the BIA or CCAA, as the case may be;
- (ii) how the debtor's business and financial affairs are to be governed during the proceedings;
- (iii) whether the debtor's management has the confidence of its major creditors;
- (iv) whether the loan agreement will enhance the debtor's prospects as a going concern if the proposal is approved;
- (v) the nature and value of the debtor's property;

¹ BIA, s. 50.6; CCAA, s. 11.2.

- (vi) whether any creditor will be materially prejudiced as a result of the debtor's continued operations; and
- (vii) the contents of the Trustee's or Monitor's report, as the case may be, including the reasonableness of cash-flow statements for the debtor.

Asset Sales

The Court also now has express statutory authority to approve any sale of a reorganizing debtor's assets made out of the ordinary course.² To resolve some inconsistency in past judicial practice and provide greater certainty to debtors and proposed purchasers, the amendments require the Court to consider:

- (i) whether the process leading to the proposed sale was reasonable in the circumstances;
- (ii) whether the trustee or monitor approved of the process leading to the proposed sale of the assets;
- (iii) whether the trustee or monitor has filed with the court a report stating that in his or her opinion the sale of the assets is necessary for a viable proposal that will provide a better result for creditors than if the assets were sold in a bankruptcy;
- (iv) the extent to which the creditors were consulted in respect of the proposed sale;
- (v) the effects of the proposed sale on creditors and other interested parties; and
- (vi) whether the consideration to be received for the assets is reasonable and fair, taking into account the market value of the assets.

If the proposed sale is to a "related" person, the Court, after considering the foregoing factors, may grant the authorization only if it is satisfied that:

- (i) good faith efforts were made to sell the assets to unrelated persons;
- (ii) the consideration that the debtor will receive is superior to the consideration that it would have received under any other offer made in the sales process; and
- (iii) the debtor can and will make any payments that would have been required for unpaid wages and pension contributions if the Court had approved the proposal or plan of arrangement.³

The Court must grant a charge over the proceeds, or other assets of the debtor, in favour of those creditors whose security is affected by a "free and clear" sale.⁴

Assignment and Disclaimer

Prior to the amendments coming into force, the BIA was silent with respect to the ability of a reorganizing debtor to disclaim executory contracts, save for real property leases. In contrast, it has been common for the Court, in CCAA proceedings, to issue orders granting the debtor a wide discretion to disclaim executory contracts. The BIA and CCAA now expressly

² BIA, s. 65.13; CCAA, s. 36.

³ BIA, ss. 65.13(5) and (8); CCAA, ss. 36(4) and (6).

⁴ BIA, s. 65.13(7); CCAA, s. 36(5).

permit the disclaimer of executory contracts.⁵ If the trustee or monitor does not approve of a proposed disclaimer, the debtor company must apply to the Court for approval. Certain protections are introduced for licensees of intellectual property during the term of the agreement, provided the licensee continues to perform its obligations under that agreement. The disclaimer provisions will not apply to derivatives and other eligible financial contracts, collective agreements, financing agreements under which the debtor is the borrower, and real property leases under which the debtor is lessor.

The Court also now has express statutory authority to grant an order assigning a contract without the consent of the other party to the contract, provided any financial defaults are remedied.⁶ The Court must consider, among other things, whether the assignee is able to perform the obligations under the agreement. Again, these provisions do not apply to certain types of agreements: eligible financial contracts, collective agreements, commercial leases, and agreements, such as personal service contracts, that are not assignable by nature.

The codification of existing practice and jurisprudence will enhance predictability, certainty, and transparency for all stakeholders. There are no more lingering doubts about many of the Court's powers, such as its ability to approve asset sales and authorize the disclaimer or assignment of contracts. Moreover, the Court is now limited in its ability to change course from the practices that have been developed to date. Parties who are not repeat participants in insolvency proceedings now have greater access to the governing rules.

Nevertheless, despite a more rules-oriented regime, it is unlikely that Court's will refrain from continuing to exercise judicial discretion. Courts will, of course, be required to fill any gaps in the current legislation. Further, given the highly dynamic and fast-moving nature of insolvency proceedings, judicial discretion will remain critical as the Court strives to balance multiple interests and craft creative solutions to a debtor's financial distress. Indeed, codification of the Court's powers may even spur greater judicial activity and shift the balance of bargaining power amongst stakeholders in insolvency proceedings. For instance, when faced with an objection from a senior secured operating lender, the Court has tended not to grant DIP financing or has limited it to the amount necessary to continue the debtor's business on a short-term basis. Now, with express statutory power to authorize such financing, it may exercise less restraint.

Governance and Receivership redux

In a complex restructuring, competent and committed directors and officers are invaluable. To help ensure they remain in the corporate fold when a filing appears imminent, the BIA and the CCAA have codified the existing practice of creating priority charges which indemnify directors and officers for post-filing liabilities.⁷ There are times, however, when an

⁵ BIA, s. 65.11; CCAA, s. 32.

⁶ BIA, s. 84.1; CCAA, s. 11.3.

⁷ BIA, s. 64.1; CCAA, s. 11.51.

insolvent debtor's directors and management resign or otherwise hinder the process through incompetence or personal agendas. The new amendments add greater discipline to the reorganization process and, thus, offer greater protection to stakeholders from governance failures.

The Court now has full discretion to remove or replace a director that may unreasonably impair the ability of a debtor to achieve a viable plan or proposal or who is unlikely to act in the debtor's best interests.⁸ The amendments also re-establish the viability of receiverships as an alternative governance mechanism through which secured creditors can preserve and sell insolvent, but operating, businesses. The Supreme Court of Canada's 2006 decision in *TCT Logistics* has had a chilling effect on going-concern bankruptcies and receiverships, particularly for businesses with significant legacy issues. Faced with potential successor liability, creditors and insolvency professionals, in many cases, have relied on "liquidating CCAAs" rather than court receiverships. In the absence of a viable receivership option, a secured creditor often must shut down the debtor's business altogether or risk watching the estate quickly diminish in value under management's control.

Before *TCT Logistics*, creditors typically relied on interim receiverships, under section 47 of the BIA, to fill a governance void and restructure a business on a national basis. Courts were willing to grant an interim receiver a very broad mandate, permitting it to take such action and exercise such control over the debtor's property and business as "the Court considers advisable", for "such term as the Court may determine". Under the new amendments, interim receivers will now play a more limited, conservatory role.⁹ Their appointment will end after 30 days or, earlier, if a trustee or section 243 receiver takes possession of the debtor's property. The Court can now order the appointment of a "national receiver" empowered to carry on the debtor's business, raise money to operate it, sell assets or the business or otherwise perform the traditional functions of a court-appointed receiver and manager.

The BIA has been expanded to protect trustees in bankruptcy, proposal trustees and receivers, and "any other person lawfully entitled to take possession or control of the debtor's property."¹⁰ Thus, privately appointed receivers and secured creditors who take possession of a debtor's property now have the same protections as a court-appointed officer. To facilitate receiverships and going-concern bankruptcies, the receiver or trustee is not liable for severance or termination pay to the extent it is calculated by reference to a period prior to the bankruptcy or receivership.¹¹

With the creation of a national receiver, and greater protection from certain pre-existing liabilities of the debtor, receiverships will once again play a prominent and critical role in commercial insolvencies.

8 BIA, s. 64; CCAA, s. 11.5.

9 BIA, ss. 47 and 243.

10 BIA, s. 14.06(1.1).

11 BIA, s. 14.06(1.2). There is a virtually identical amendment to the CCAA, s. 11.8, that protects monitors from personal liability when carrying on the business of the debtor.

Increased Litigation Risk

The new amendments may give rise to more U.S.-style litigation and litigation trusts for the benefit of unsecured creditors. Litigation is generally perceived as anathema to a reorganization process that encourages stakeholders to negotiate a fully consensual plan for court approval. Nevertheless, legal claims constitute property of the estate and, therefore, to maximize the estate's value it is beneficial to provide trustees and monitors with improved mechanisms through which to pursue these claims until they are ripe for settlement.

Sections 95 and 96 of the BIA overhaul the statutory remedies for scrutinizing avoidance transactions and Section 36.1 of the CCAA expressly imports these provisions. The look-back period for non-arm's length transfers is extended to one year from the initial bankruptcy event and there is no requirement to prove an intent to prefer, only an "effect of preferring". Further, a trustee and now a monitor can attack a "transfer at undervalue", defined as a disposition of property or provision of services for which the debtor receives consideration that is "conspicuously less" than fair market value.¹² For a transfer at undervalue between parties at arm's length, the trustee or monitor must establish that (i) the transfer occurred within a year of the initial bankruptcy event; (ii) the debtor was insolvent at the time of the transfer or was rendered insolvent by it; and (iii) the debtor intended to defraud, defeat or delay a creditor. For a non-arm's length transfer at undervalue, the transfer will be void if it occurred within a year of the initial bankruptcy event. The look-back period is extended to five years if the debtor was insolvent at the time of the transfer, was rendered insolvent by the transfer, or intended to defraud, defeat, or delay a creditor.

These new avoidance transaction provisions are likely to play a more prominent role in future insolvencies. They may prove particularly useful in the context of reorganizations arising from leveraged financial transactions. A trustee or monitor may seek to challenge a transaction where, as a result of false or incorrect financial projections, the now insolvent target took on indebtedness without any benefit to it, while proceeds from the debt were paid out to the target's shareholders or a related company.

Litigation in an insolvency proceeding can become complex and costly, with extensive documentation and financial analysis leading to protracted discovery, motions, and appeals. Even with more favourable provisions addressing preferences and transfers at undervalue, the trustee or monitor may still not pursue these claims because the debtor or secured creditors are hoping for a quick reorganization. The new amendments, however, also facilitate the role of creditors committees and unsecured creditors may now have greater input into how best to maximize the value of the debtor's estate, whether through litigation or otherwise.

¹² BIA, s.2.

In U.S. Chapter 11 proceedings, creditors committees are created in every case to actively monitor the debtor's progress and participate in the formation of a plan that is fair and reasonable to unsecured creditors. Creditors committees avoid a wasteful duplication of effort by individual creditors and enable those creditors to speak with a unified voice, which strengthens their credibility with the Court. Canadian courts have approved the creation of creditors committees in significant cases without express statutory power to do so. The new amendments facilitate effective participation of creditors committees in the reorganization process by permitting a charge over the debtor's property in respect of certain expenses of "interested parties".¹³ Unsecured creditors, therefore, gain some leverage at the expense of debtors and secured creditors.

Creditors committees may also become more important in light of the adoption, in both the BIA and CCAA, of a form of the UNCITRAL Model Law in respect of cross-border insolvencies.¹⁴ When a Canadian court issues an order recognizing a foreign proceeding, the Canadian court must cooperate with the foreign representative and the foreign court involved. Now that foreign representatives have greater rights and powers with respect to the possession and distribution of a debtor's assets, a committee may be required to safeguard the interests of Canadian creditors.

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The full impact of the new amendments on creditors, debtors, and other stakeholders remains to be seen. Though they raise the prospect of more U.S.-style litigation in the future, the changes will, for the most part, enhance the efficiency and effectiveness of Canada's insolvency regime as it continues to deal with rapid changes in corporate enterprises, fall-out from business and capital market failures, and an uncertain economic environment.

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¹³ BIA, s. 64.2; CCAA, s. 11.52.

¹⁴ BIA, Part XIII; CCAA, Part IV.

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a cautionary note

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted. © McMillan LLP 2009.