

# BANKING & FINANCE

**LAW REVIEW**

Revue de droit bancaire et de finance

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# Canadian Business Restructuring Law: When Should a Court say “No”?

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*For the past twenty-five years the Canadian business insolvency system has moved from focusing on sale proceedings conducted principally for the direct benefit of creditors to reorganization proceedings controlled by the debtor. Many of the extraordinary powers granted to debtors to effect such reorganizations were first authorized by the exercise of judicial discretion rather than as a result of legislative reform. However, the statutes and case law give little guidance on governance issues, so by default, the courts have looked to corporate law developed for solvent entities acting without extraordinary powers. The courts have shied away from policing the exercise of those extraordinary powers (a number of which will soon be codified) and have proactively limited the role of the creditors in restructuring proceedings, fearing that empowering the creditors would tend to put the “success” of the restructuring proceedings at risk. As a result, Canada now has a system that encourages reorganizations by the debtor but has few meaningful checks and balances. It is clear that the implications of this result have not been weighed in the balance. Unless one believes that any “restructuring” is inherently better than the alternatives, there are good reasons to be concerned about these implications.*

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*Au cours des vingt-cinq dernières années, le système canadien d'insolvabilité commerciale a évolué, passant d'un système axé sur des opérations de vente réalisées principalement à l'avantage direct de créanciers à un système axé sur des réorganisations contrôlées par le débiteur. Bon nombre des pouvoirs extraordinaires conférés aux débiteurs pour réaliser des réorganisations ont été d'abord autorisés suite à l'exercice de pouvoirs judiciaires discrétionnaires plutôt que par suite à des réformes législatives. Les lois et la jurisprudence encadrent peu les questions de gouvernance en ce domaine; par conséquent, les tribunaux se sont inspirés sur ces questions du droit des sociétés, rédigé pour des entités solvables agissant sans pouvoirs extraordinaires. Les tribunaux ont évité de réglementer l'exercice de ces pouvoirs extraordinaires (dont un certain nombre seront bientôt codifiés) et ont limité de façon proactive le rôle des créanciers dans les instances de restructuration, par crainte que ceux-ci en*

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compromettent la réussite. Par conséquent, le Canada dispose maintenant d'un système qui encourage les réorganisations par le débiteur mais compte peu de mécanismes régulateurs. Il est clair que les effets de cet aboutissement n'ont pas été suffisamment évalués. À moins que l'on ne soit d'avis que toute « restructuration » est, de par sa nature, préférable aux autres solutions de rechange, il existe de bonnes raisons de procéder à cette évaluation.

## 1. INTRODUCTION

Over the past few years the primary focus of insolvency law reform efforts has centred around the introduction of Bill C-55, now enacted as *An 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*<sup>1</sup> (the "Reform Act"). First passed by the House of Commons in November, 2005, the *Reform Act* has undergone an unusual journey towards proclamation. Due to a number of technical deficiencies arising from the draft as passed, the *Reform Act* was not proclaimed into force after it was passed. Bill C-12<sup>2</sup> which corrected many technical defects contained in the *Reform Act* was passed by the House of Commons and received royal assent in December, 2007. Although the *Reform Act* still remains the subject of Senate committee hearings, the *Reform Act*, as amended by Bill C-12, is scheduled to be proclaimed into force during 2008.

The *Reform Act* represents the first major statutory reform initiative since the 1997 amendments to Canadian bankruptcy law. On their face, a substantial number of the amendments to business bankruptcy law contained in the *Reform Act* represent a codification of practices developed over the last ten to fifteen years. For example, the *Reform Act* expressly provides for debtor-in-possession financing ("DIP financing"), creates a scheme for disclaiming or assigning executory contracts and provides for authority to conduct a sale of a business as part of a restructuring proceeding.

As a result of the lack of statutory guidance, much of Canadian restructuring law was developed on an ad hoc basis through the use of judicial discretion and an increasingly broad interpretation of the Court's

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<sup>1</sup> S.C. 2005, c. 47 [Statute c. 47].

<sup>2</sup> Bill C-12 was enacted as: *An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005, S.C. 2007, c. 36.*

inherent or implied jurisdiction. Codifying existing restructuring practices represents a move towards a more black-letter law approach to restructuring in Canada. This may tend to support what appears to be a recent retrenchment of the use of inherent jurisdiction by the Courts.

Perhaps more fundamentally, the *Reform Act* signifies an express acceptance of a rescue or rehabilitative philosophy of insolvency law. Certainly, as an historical matter, insolvency law in Canada (and the United Kingdom from which much early Canadian commercial insolvency concepts were derived) has consistently supported an insolvency system that was both an efficient method of distributing assets among creditors and a vehicle for achieving certain social and economic policy goals.<sup>3</sup> Nevertheless, until recently Canada's commercial insolvency legislation focused primarily on setting out a scheme for the redistribution of the proceeds of the assets of a failed enterprise in a manner that was fair and equitable.<sup>4</sup> The *Companies' Creditors Arrangement Act*<sup>5</sup> (the "CCAA") (enacted in 1933) was available to effect the restructuring of insolvent companies outside of bankruptcy. However, it was not until the 1980's that the spirit of the rescue culture resurrected this largely unused statute and elevated it to Canada's primary restructuring statute for large enterprises.<sup>6</sup>

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<sup>3</sup> Consider, for example, the advice of the president of the English board of trade to the English House of Commons in connection with the debates over the *Bankruptcy Act*, 1883: . . .to keep in mind two main, and, at the same time, distinct objects of any good Bankruptcy Law. Those were, firstly, in the honest administration of bankrupt estates, with a view to the fair and speedy distribution of the assets among the creditors, whose property they were; and, in the second place their object should be, following the idea that prevention was better than cure, to do something to improve the general tone of commercial morality, to promote honest trading, and to lessen the number of failures. See Richard. H. McLaren, *Canadian Commercial Reorganization*, loose leaf vol.1 (Aurora: Canada Law Books, 1994) at 1-20.

<sup>4</sup> For example, while the ability to make a proposal to ones creditors has been a part of Canadian bankruptcy law since the introduction of the *Bankruptcy Act* of 1919, it was only after the 1949 amendments that a debtor could make a proposal to its creditors without first making an assignment or having a receiving order made against it. Furthermore, it was not until the major overhaul of the bankruptcy regime in 1992 that a debtor was given the benefit of a stay of proceedings against secured creditors on the filing of a notice of intention. See McLaren, *ibid.*, at 1-5 to 1-6.

<sup>5</sup> R.S.C. 1985, c. C-36 [CCAA].

<sup>6</sup> Indeed, at the time of its enactment, the CCAA was meant to be used only by companies with secured indebtedness on the understanding that debenture holders (represented by a debenture trustee) had sufficient leverage to affect a fair compromise with the debtor, without the necessity for government regulation of the process. The rise in the use of the CCAA by companies with only unsecured debt and the recognition that unsecured creditors

The recent reforms focus principally on establishing a framework for restructuring by giving a debtor the tools (such as DIP financing) necessary to effect a successful restructuring of its business and debts. The *Reform Act* is noticeably silent in providing debtors with any guidance and direction as to how to use these tools to reach a successful result and, perhaps more importantly, what is a successful restructuring. Similarly, creditors, monitors, and other insolvency protagonists operating within this framework have little basis for establishing what the debtor's objective should be and consequently have no real ability to act as an appropriate check on the restructuring process.

Unfortunately, there is little guidance to be found in the jurisprudence beyond basic statements relating to the purpose of the *CCAA*. Courts have generally held that the purpose of the *CCAA* is "to preserve an insolvent company as a viable operation and to reorganize its affairs to the benefit not only of the debtor but of the creditors."<sup>7</sup> Implicit in this purpose is the belief that restructurings have such economic and social value as to render them preferable to liquidation or sale. It has been argued that from a macroeconomic perspective, there is little to be gained in liquidating viable enterprises that are experiencing temporary financial hardship.<sup>8</sup>

The flaw in these types of superficially attractive but vague statements is that they lack a fundamental theoretical basis upon which we can formulate concrete objectives. In the United States there are competing theories of bankruptcy law. For example, one theory, the creditor's bargain theory,<sup>9</sup> focuses on the position and expectations of creditors. Alternatively, we could adopt Professor Warren's position that bankruptcy reorganization should preserve the debtor's business for the benefit of many constituencies, such as employees, customers, and sup-

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did not have sufficient power to bargain with the debtor almost led to the Act's repeal in 1938. See McLaren, *supra*, n. 3 at 1-14.

<sup>7</sup> Lloyd W. Houlden & Geoffrey B. Morawetz, *The 2007 Annotated Bankruptcy and Insolvency Act* (Toronto: Carswell, 2007) N§1, citing *Quintette Coal Ltd. v. Nippon Steel Corp.* (1990), 80 C.B.R. (N.S.) 98, 1990 CarswellBC 425 (B.C. S.C.) and *Milner Greenhouses Ltd. v. Saskatchewan*, 2004 CarswellSask 280, [2004] S.J. No. 264, 2004 SKQB 160, 50 C.B.R. (4th) 214, [2004] 9 W.W.R. 310, 48 B.L.R. (3d) 276, 252 Sask. R. 42 (Sask. Q.B.).

<sup>8</sup> McLaren, *supra*, n. 3 at 1-20.

<sup>9</sup> See Thomas H. Jackson, "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain" (1982) 91 Yale L.J. 857; Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (Cambridge, MA: Harvard University Press, 1986).

pliers and judge the success of a restructuring by how many jobs were saved or customer/supplier relationships maintained.<sup>10</sup>

It is unclear what theory informs Canadian insolvency laws. Is the primary value simply to get to a restructuring deal, whatever that deal may be?

Consider for instance the position of debtor's counsel advising its client on the eve of a CCAA filing. Should counsel tell the debtor's board of directors that post-filing it should look only to protection of shareholder interests and the enterprise as a whole because Canadian corporate law does not recognize a shift in the board's duties to creditors within an insolvency? Should counsel advise the debtor to terminate its employees and make termination and severance payments before the filing on the basis that the employees, particularly unionized employees, are more likely to put up an organized fight, while unsecured creditors have less capacity to advance their interests? Should counsel assure the debtor that in all likelihood any plan put forward by the debtor will be approved by the court (even where substantive rights of third parties, like landlords, are compromised or unilaterally changed), as long as the result is said to be better than a liquidation? There are no simple answers to these questions and counsel, whose primary duty is to serve the interests of the client, must advise the debtor to act in a manner that is advantageous to the debtor's interests, without regard to the consequences such actions may have on the restructuring system as a whole.

The absence of definitive guidance and rules governing the behaviour of the debtor in an insolvency has resulted in the transfer of the governance burden (perhaps unfairly) to the judiciary who must maintain the integrity of the system through the exercise of judicial discretion and inherent jurisdiction. However, the nature of the Canadian judicial process is such that it requires courts to adjudicate specific disputes between particular parties. While a court can and must be relied on implicitly to adjudicate such matters in a manner that is fair and just, the case-by-case consideration of issues is not always conducive to promoting high level policy objectives. For example, the decision of a court to approve a particular course of conduct while justifiable in the circumstances,

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<sup>10</sup> Elizabeth Warren, "Bankruptcy Policy" (1987) 54 U. Chicago L. Rev. 75; cf. Douglas Baird, "Loss Distribution, Forum Shopping and Bankruptcy: A Reply to Professor Warren" (1987) 54 U. Chicago L. Rev. 815.

may lead to injustices in the future. In the absence of specific legislative rules that speak to when and, in what circumstances, such conduct should be approved, that one decision of the court is itself elevated to a “rule” which must be followed or at least considered in every subsequent case. The result is that courts have become bound by a set of decisions made (in large part) to address very specific disputes and facts and which together do not necessarily reflect the principles that would collectively have been agreed upon by parties designing the system.

What is clear is that when it comes to the governance of parties participating in a restructuring process, particularly the debtor, there is a gap in the legislation. While this gap has, to a certain extent, been filled by corporate law and by the common law or the civil code on an ad hoc basis, it does not provide the “necessary degree of predictability and consistency in the application of the law, which is essential to investors, creditors, employees and other interested parties in developing a successful restructuring plan.”<sup>11</sup>

The purpose of this article is to discuss the existing parameters that limit a debtor’s use of the restructuring powers now available to it. Or put another way, when should a court say “no” to a debtor?

## 2. THE DEBTOR

Since most Canadian businesses involve corporations, a logical place to start the analysis of the rules that should govern the debtor is to consider the principles that apply to the governance of corporations.

In Canada, corporate governance laws are based on the *Canada Business Corporations Act*<sup>12</sup> (the “CBCA”) and that Act’s provincial counterparts, as well as on common law principles derived from case law and rules that are imposed by stock exchanges and provincial securities laws. The management of corporations is overseen by the directors, who under section 102(1) of the CBCA are granted authority, subject to any unanimous shareholder agreement, to manage or supervise the management of, the business and affairs of a corporation. In managing

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<sup>11</sup> See Industry Canada, “Questions and Answers on the Amendments to the Bankruptcy and Insolvency Act and the Companies’ Creditors Arrangements Act” (Created: June 1, 2005). Available online: <<http://www.ic.gc.ca/epic/site/cilp-pdci.nsf/en/ci00782e.html>>.

<sup>12</sup> R.S.C. 1985, c. C-44 [CBCA].

the corporation, the directors must govern in accordance with section 122(1) of the *CBCA*, which states that:

Every director and officer of a corporation in exercising their powers and discharging their duties shall:

- (a) act honestly and in good faith with a view to the best interests of the corporation; and
- (b) exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances.

These two directions outline what is at the core of corporate governance law in Canada. The decisions of directors must (a) be in the best interests of the corporation, commonly referred to as the fiduciary duty, and (b), those decisions must be made using the skill and judgment of the director to a standard of a reasonably prudent person in the circumstance that the director is in, commonly referred to as the duty of care.

The goals and standards of the two duties described above have been given more concrete meaning by the courts. The *CBCA* uses the phrase “in the best interest of the corporation,” but does not define which of the various stakeholders’ interests should be considered, and how those interests should be balanced. Ever since Berle and Dodd debated this question over 75 years ago, the question of to whom directors owe their loyalty has been considered, with no satisfactory conclusion.<sup>13</sup> In Canada, the Supreme Court considered this question in *People’s Department Stores Ltd. (1992) Inc., Re.*<sup>14</sup> The Supreme Court was considering whether the fiduciary duties of the directors should shift to looking out for the interests of creditors where a corporation is nearing insolvency and it appears that a bankruptcy proceeding is likely. The Supreme Court answered this question by stating that the duty is not owed to one particular stakeholder, but to the corporation itself.<sup>15</sup> The Supreme Court interpreted the best interests of the corporation to mean the maximization of value of the corporation, and to that end, the interests of various stakeholders may be considered:

<sup>13</sup> E.M. Dodd, “For Whom Are Corporate Managers Trustees?” (1932) 45 Harv. L. Rev. 1049; A.A. Berle, “For Whom Corporate Managers Are Trustees” (1933) 45 Harv. L. Rev. 1365.

<sup>14</sup> 2004 CarswellQue 2862, 2004 CarswellQue 2863, [2004] S.C.J. No. 64, REJB 2004-72160, 326 N.R. 267 (Eng.), 326 N.R. 267 (Fr.), 4 C.B.R. (5th) 215, [2004] 3 S.C.R. 461, 2004 SCC 68, 244 D.L.R. (4th) 564, 49 B.L.R. (3d) 165 (S.C.C.) [*Peoples*].

<sup>15</sup> *Ibid.*

We accept as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, *inter alia*, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.<sup>16</sup>

The decision by the Supreme Court to interpret the duty of directors as one towards “the corporation” does not, however, answer the question of how to balance stakeholder interests when those interests might be at odds. The Supreme Court noted that “where the corporation is profitable and well capitalized and has strong prospects” the interests of shareholders and creditors may be consistent with each other.<sup>17</sup> However, in *Peoples* the corporation had entered bankruptcy proceedings, and the trustee in bankruptcy was unsatisfied with some of the business decisions that the directors made before bankruptcy which it felt were unfair and eroded the estate’s value, sacrificing the interests of a group of creditors.<sup>18</sup> The questions that the Supreme Court had to answer in *Peoples* had to do with how to consider the interests of creditors when “the corporation approaches what has been called “the vicinity of insolvency,” when the residual claims of shareholders will be nearly exhausted.<sup>19</sup> The Supreme Court dismissed any conflict by not recognizing any direct duty to the shareholders or creditors, but in maintaining that the director’s fiduciary duty was only to the corporation.

The Supreme Court’s consideration of whether directors’ duties shift as a corporation reaches the vicinity of insolvency denies that there should be a shift in interest depending on the state of the corporation:

The various shifts in interests that naturally occur as a corporation’s fortunes rise and fall do not, however, affect the content of the fiduciary duty under s. 122(1)(a) of the *CBCA*. At all times, directors and officers owe their fiduciary obligation to the corporation. The interests of the corporation are not to be confused with the interests of the creditors or those of any other stakeholders.<sup>20</sup>

The Supreme Court maintains that there is one clear interest, that of the corporation, that can be maintained during financial difficulties. This allows the directors to avoid considering conflicting interests, as one observer has interpreted the Supreme Court decision:

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<sup>16</sup> *Ibid.*, at para. 42.

<sup>17</sup> *Ibid.*, at para. 44.

<sup>18</sup> *Ibid.*, at para. 23.

<sup>19</sup> *Ibid.*, at para. 45.

<sup>20</sup> *Ibid.*, at para. 43.

If a fiduciary duty were owed directly to creditors, directors could, among other things, face potentially conflicting duties between two manifestly opposing parties. Even if a company is insolvent or in the vicinity of insolvency, the duties of directors to it continue unabated. If, at the same time, directors owed duties to creditors of the company, an irreconcilable conflict would arise when, for example, directors seek additional credit for the company. Do they vigorously pursue the additional credit, thereby deepening the insolvency at the expense of creditors? Or do the directors disclose the company's financial plight, killing the company's chances of survival but minimizing the exposure of creditors. The Court's decision avoids hoisting directors on the horns of this potential conflict by clearly stating *that the duty of directors never shifts and that, at least before bankruptcy, the interests of shareholders and creditors are always aligned.*<sup>21</sup>

However, arguing that the interests of the corporation, including those of the shareholders and creditors are always aligned before bankruptcy may ignore some conflicts in the interests of these stakeholders. For example, consider a situation where a corporation is near insolvent with little residual value remaining for shareholders. However, there is an opportunity to 'bet the farm' in a strategy that might result in value for shareholders if successful, but leave little value for creditors in the likely event of failure. In such a situation, clearly the interests of the shareholders and creditors are not aligned.

If the duty of the directors is to the corporation, as decided by the Supreme Court, it should be asked whether that can include the value of the corporation in a liquidation or restructuring, options not mentioned by the Court in *Peoples*. Whether the interests of the corporation can be held separate from those of its stakeholders is a matter for debate and interpretation,<sup>22</sup> and given that as the example above shows there can be opposing interests amongst stakeholders, it is unclear what guidance can be derived by directors considering the interests of the corporation, as opposed to the interest of its stakeholders.

In *Stelco Inc., Re*<sup>23</sup> the Ontario Court of Appeal considered the issue of corporate governance in the context of a company that had already entered a restructuring process under the CCAA. The appeal arose from a decision at the Superior Court to remove two directors appointed at

<sup>21</sup> Wayne D. Gray, "A Solicitor's Perspective on *Peoples v. Wise*" (2005) 41 Can. Bus. L.J. 184 at 188.

<sup>22</sup> Ian B. Lee, "*Peoples Department Stores v. Wise and the 'best interests of the corporation'*" (2005) 41 Can. Bus. L.J. 212.

<sup>23</sup> (2005), [2005] O.J. No. 1171, 2005 CarswellOnt 1188, 253 D.L.R. (4th) 109, 75 O.R. (3d) 5, 2 B.L.R. (4th) 238, 9 C.B.R. (5th) 135, 196 O.A.C. 142 (Ont. C.A.).

the request of the existing shareholders to the board during the restructuring process that had been made by Justice Farley who was supervising that process.<sup>24</sup> Some of the unsecured creditors of Stelco feared that the involvement of the new directors would lead to a restructuring process focused mainly on maximizing shareholder value at the expense of their interests. Justice Farley held that a supervising court can interfere with the composition of a board where there is sufficient reason to do so under the authority of section 11 of the *CCAA*. Section 11 gives the supervising judge in a *CCAA* proceeding broad powers to, where considered appropriate and on an application made under the *CCAA*, make an order.<sup>25</sup> In this case, Justice Farley was not prepared to adopt a “wait and see” approach in determining whether the directors would act in the best interests of the corporation, and used what he argued was the supervisory court’s inherent jurisdiction to order that the two directors be removed from the board.<sup>26</sup>

In the unanimous appeal decision written by Justice Blair, the Ontario Court of Appeal overturned the Superior Court’s ruling and reinstated the two new directors to the board.<sup>27</sup> The Court of Appeal rejected Justice Farley’s conclusion that a supervising court has the power to remove directors based on its inherent jurisdiction and its discretion under section 11 of the *CCAA*. The Court of Appeal found that a court should not step into the shoes of the directors, and that the governance of the company remains with the directors and the board during the restructuring process. Justice Blair wrote that:

Although a judge supervising a *CCAA* proceeding develops a certain “feel” for the corporate dynamics and a certain sense of direction for the restructuring, this caution is worth keeping in mind. The court is not catapulted into the shoes of the board of directors, or into the seat of the chair of the board, when acting in its supervisory role in the restructuring.<sup>28</sup>

The Court of Appeal found that section 11 only gives the supervising court a role in the process in so much as it can prevent the directors

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<sup>24</sup> (2005), 2005 CarswellOnt 742, [2005] O.J. No. 729, 7 C.B.R. (5th) 307 (Ont. S.C.J. [Commercial List]); additional reasons at (2005), [2005] O.J. No. 730, 2005 CarswellOnt 743, 7 C.B.R. (5th) 310 (Ont. S.C.J. [Commercial List]); reversed (2005), [2005] O.J. No. 1171, 2005 CarswellOnt 1188, 253 D.L.R. (4th) 109, 75 O.R. (3d) 5, 2 B.L.R. (4th) 238, 9 C.B.R. (5th) 135, 196 O.A.C. 142 (Ont. C.A.).

<sup>25</sup> *CCAA*, *supra*, n. 5, s. 11(1).

<sup>26</sup> *Supra*, n. 24, at paras. 23-24.

<sup>27</sup> *Supra*, n. 24.

<sup>28</sup> *Supra*, n. 23 at para. 68 [citations omitted].

from taking certain actions as outlined in the CCAA. Justice Blair found that:

What the court does under s. 11 is to establish the boundaries of the playing field and act as a referee in the process. The company's role in the restructuring, and that of its stakeholders, is to work out a plan or compromise that a sufficient percentage of creditors will accept and the court will approve and sanction. The corporate activities that take place in the course of the workout are governed by the legislation and legal principles that normally apply to such activities. In the course of acting as referee, the court has great leeway, as Farley J. observed in *Lehndorff, supra*, at para 5, "to make order[s] so as to effectively maintain the status quo in respect of an insolvent company while it attempts to gain the approval of its creditors for the proposed compromise or arrangement which will be to the benefit of both the company and its creditors". But the s. 11 discretion is not open-ended and unfettered. Its exercise must be guided by the scheme and object of the Act and by the legal principles that govern corporate law issues. Moreover, the court is not entitled to usurp the role of the directors and management in conducting what are in substance *the company's* restructuring efforts.<sup>29</sup>

Although the Court of Appeal decided that there was no role in section 11 of the CCAA for a court to restrict the appointment of directors, the Court of Appeal did observe that under section 20 of the CCAA there was a way to bring in the oppression remedy and other provisions of the CBCA.

The combined effect of the *Peoples* and *Stelco* decisions is arguably to leave a vacuum. One way of interpreting *Peoples* is to say that the fiduciary duty concept is principally directed at self-dealing, and that absent self-dealing the directors will not be liable for breach of fiduciary duty. If so, the fiduciary duty does not inform the directors about how and why the extraordinary powers of a debtor in a reorganization are to be exercised.

The directors are also subject to the standard of care under applicable corporate law. A key task of debtor's counsel in a restructuring proceeding is to advise the board about the processes to follow and what management and expert reports should be received in order to be able to document that the standard of care has been met. But this is ultimately a defensive exercise engaged in for the purpose of building protections against personal claims against the directors. It does not inform the board or the debtor about what should actually be done with the debtor's restructuring powers.

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<sup>29</sup> *Ibid.*, at para. 44.

As is apparent in the discussion above, the *CBCA* does not give specific direction on governance during an insolvency proceeding or restructuring. The *CBCA* is designed with the governance of solvent companies in mind, and primarily addresses the agency problems associated with the separation of ownership and control. The *CBCA*, for the most part, does not govern the relationship of companies and creditors, with the understanding that creditors are able to make contracts to protect themselves. However, where a court orders a stay under the *CCAA*, the creditors lose their contractual protection, and thus the assumptions made by the *CBCA* are not reflected in the resulting situation.

The Court of Appeal decision in *Stelco* refers to corporate law without recognizing that it was not developed with insolvency proceedings in mind. The decision then amplifies the corporate law vacuum by defining the role of the courts in a restructuring proceeding as in effect being “hands off the debtor.” Its primary justification for that role is a fiction that the role of the court is to preserve the “status quo” pending a vote by the creditors on a restructuring plan.

It is inherent in the restructuring process that there be material changes in the status quo. It may be necessary for the debtor to borrow new funds secured in priority to pre-filing secured loans, to sell assets in breach of pre-filing covenants, and to terminate pre-filing contracts without paying damages for breach. These steps and many others are generally taken by the debtor before a plan is approved, often without any form of creditor approval and relying solely on the approval of the court.

In practice, a common strategy of a debtor in a restructuring proceeding is actually to try to alter the status quo before a vote is taken to such a degree that the creditors have no choice but to accept the ultimate restructuring plan as a *fait accomplis*. Canadian courts have repeatedly used their powers to assist debtors in this endeavour.

However, one can argue that the “hands off the debtor” approach is still correct even if the status quo rationale for it is wrong. A restructuring can involve many practical business decisions that are beyond the expertise of the court. It can be cogently argued as a result that it would not be appropriate for a court to second guess management. One consequence of that view is that it renders the court approval process largely meaningless. And what then are the checks and balances on the debtor?

Finally, the uncertainties in the law have been compounded by the fact that the result in *Stelco* has in substance been overturned by the *Reform Act*. The *Reform Act* gives the courts the express power to remove directors during reorganization proceedings in certain circumstances. What does that do to the rationale of the *Stelco* decision?

### 3. CCAA MONITOR

One possible counterweight to the powers given to the debtor under the Canadian system is provided by the requirement in *CCAA* proceedings to have a “monitor,” and in *BIA* proceedings to have a trustee.

The requirement for an appointment by the court of a monitor in *CCAA* proceedings is a relatively new development. Prior to 1997, the *CCAA* did not require the appointment of a monitor. However, in the years prior to that time a practice developed of having the court appoint an accounting firm to perform an officially sanctioned role in the *CCAA* proceedings. At a time when there was relatively more suspicion about the restructuring process, their role was often analogized to that of an interim receiver appointed under section 46 of the *BIA* to monitor the debtor’s conduct while a disputed bankruptcy petition is outstanding. Indeed, in *CCAA* cases in the 1980s the monitors were often called “Interim Receivers”. (See for example, *Re United Co-Operatives of Ontario*<sup>30</sup> and *Northland Properties Ltd., Re.*<sup>31</sup>) They could be selected and appointed directly or indirectly at the instigation of key creditors as a watchdog to observe the conduct of management and the operation of the business while a plan was being formulated. Over time, wise debtors co-opted the process by asking the court to appoint “their” accounting firm to forestall the appointment of a different firm selected by the creditors.

One practical issue that led to the judicial appointment of accounting firms was the protection of fees. When creditors instigated the appointment, they wanted the fees paid for by the debtor, and when the debtor instigated the appointment, the accountants wanted security of payment. After some judicial doubt, it was concluded that the court had

<sup>30</sup> (August 1984), unreported.

<sup>31</sup> (1988), 1988 CarswellBC 558, 73 C.B.R. (N.S.) 175 (B.C. S.C.); affirmed [1989] B.C.J. No. 63, 1989 CarswellBC 334, 73 C.B.R. (N.S.) 195, [1989] 3 W.W.R. 363, 34 B.C.L.R. (2d) 122 (B.C. C.A.).

the jurisdiction to protect the fees on the basis that once appointed, the accounting firm was either an officer or an agent of the court.<sup>32</sup>

During the development of the 1997 round of insolvency law reform, the Bankruptcy and Insolvency Advisory Committee (“BIAC”) task force studying the CCAA recommended that the appointment of a monitor be made mandatory so as to “give creditors in CCAA applications the same protection of a professional and impartial “watchdog”, as is provided to creditors in BIA reorganizations.”<sup>33</sup> When the CCAA was amended in 1997 to require the appointment of a monitor, the statutory language used to describe the monitor’s role was consistent with the watchdog concept. The basic purpose of the appointment was described as being “to monitor the business and financial affairs of the company while the [initial order] remains in effect.”<sup>34</sup> The monitor was given express access to the debtor’s books, records and property for the purpose, and was required to report “on the state of the company’s business and financial affairs”<sup>35</sup> if there was a material adverse change in the debtor’s projected cash-flow or financial circumstances and also prior to creditor meetings. There were no other express powers or duties.

The court was given the power to order the monitor “to carry out such other functions in relation to the company as the court may direct.”<sup>36</sup> This catch all provision has been used to adjust the role of the monitor on a case-by-case basis. It is now typical for an initial order under the CCAA to have numerous provisions dealing with the powers and duties of the monitor.

In most CCAA cases, the monitor plays a broader role than watchdog. In practice, the monitor plays an expanded role that depends firstly

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<sup>32</sup> *Starcom International Optics Corp., Re* (1998), 1998 CarswellBC 477, [1998] B.C.J. No. 506, 3 C.B.R. (4th) 177 (B.C. S.C. [In Chambers]); *Fairview Industries Ltd., Re* (1991), 297 A.P.R. 12, 109 N.S.R. (2d) 12, 11 C.B.R. (3d) 43, 1991 CarswellNS 35 (N.S. T.D.) [Fairview]; *Canadian Asbestos Services Ltd. v. Bank of Montreal*, 1992 CarswellOnt 936, [1992] O.J. No. 2320, 16 C.B.R. (3d) 114, [1992] G.S.T.C. 15, 11 O.R. (3d) 353, 5 T.C.T. 4328, 93 D.T.C. 5001, 5 C.L.R. (2d) 54, [1993] 1 C.T.C. 48 (Ont. Gen. Div.); additional reasons at 1993 CarswellOnt 816, 13 O.R. (3d) 291, 10 C.L.R. (2d) 204, [1993] G.S.T.C. 23, 1 G.T.C. 6169 (Ont. Gen. Div.).

<sup>33</sup> Report of the Task Force on the CCAA to the Bankruptcy and Insolvency Advisory Committee Working Group on Commercial Reorganizations, Bankruptcies and Receiverships, 1994 at 3.

<sup>34</sup> CCAA, *supra*, n. 5, s. 11.7(1).

<sup>35</sup> *Ibid.*, s. 11.7(3)(b).

<sup>36</sup> *Ibid.*, s. 11.7(3)(d).

on management and secondly, where there are key creditors or groups of creditors, on the relationship between management and those key creditors. In practice, monitors are hired by the debtor and in substance often act as an advisor to the debtor, albeit with special responsibilities.

The role of the monitor is further confused by the role the monitor plays in court during proceedings under the CCAA. Because the monitor is appointed by the court, early on the courts concluded that the monitor was either an agent of the court<sup>37</sup> or an officer of the court.<sup>38</sup> The courts have also concluded that the monitor has an “obligation to act independently and to consider the interest of the petitioners and its creditors.”<sup>39</sup> In one pre-1997 case, the Court commented:

It is essential for the court to ensure that neither the shareholders nor the creditors have any influence over the monitor. As an agent of the court, the monitor must not be in a “conflict of interest” situation. The monitor’s sole responsibility is to the court.<sup>40</sup>

The fact that the monitor has been adviser to the debtor before the filing has not been considered problematic.<sup>41</sup> However, disclosure at the time of the appointment is the correct practice and may be required under applicable professional rules.<sup>42</sup>

Justice Farley commented in one case that the monitor “recognizes its role is to be neutral and to act in the best interests of all concerned.”<sup>43</sup> In another, he noted that there was no jurisprudence to support an ar-

<sup>37</sup> *Fairview*, *supra*, n. 32, Glube C.J.T.D. at para. 75. See also *Siscoe & Savoie v. Royal Bank* (1994), 404 A.P.R. 42, 157 N.B.R. (2d) 42, 29 C.B.R. (3d) 1, 1994 CarswellNB 14 (N.B. C.A.); leave to appeal refused (1995), 32 C.B.R. (3d) 179n (S.C.C.) at para. 28.

<sup>38</sup> *United Used Auto & Truck Parts Ltd., Re* (1999), 1999 CarswellBC 2673, [1999] B.C.J. No. 2754, 12 C.B.R. (4th) 144 (B.C. S.C. [In Chambers]); affirmed 2000 CarswellBC 414, [2000] B.C.J. No. 409, 2000 BCCA 146, 135 B.C.A.C. 96, 221 W.A.C. 96, 73 B.C.L.R. (3d) 236, 16 C.B.R. (4th) 141, [2000] 5 W.W.R. 178 (B.C. C.A.); leave to appeal allowed (2000), 2000 CarswellBC 2132, 2000 CarswellBC 2133, [2000] S.C.C.A. No. 142, 261 N.R. 196 (note), 149 B.C.A.C. 160 (note), 244 W.A.C. 160 (note) (S.C.C.) at para. 20 [*United*].

<sup>39</sup> *Ibid.*

<sup>40</sup> *Stokes Building Supplies Ltd., Re* (1992), 1992 CarswellNfld 20, 318 A.P.R. 114, 100 Nfld. & P.E.I.R. 114, 13 C.B.R. (3d) 10 (Nfld. T.D.) at para. 15.

<sup>41</sup> *United*, *supra*, n. 38.

<sup>42</sup> Rules of Professional Conduct and Interpretation, Canadian Association of Insolvency and Restructuring Professionals, “Interpretations to the Rules,” Rule 6, online: <[http://www.cairp.ca/english/regulation\\_members/rules\\_of\\_conduct.asp](http://www.cairp.ca/english/regulation_members/rules_of_conduct.asp)>.

<sup>43</sup> *Royal Oak Mines Inc. Re* (1999), [1999] O.J. No. 1369, 11 C.B.R. (4th) 122, 1999 CarswellOnt 1068 (Ont. Gen. Div. [Commercial List]) at para. 6.

gument that a monitor represents the interest of the creditors in the same way as a trustee in bankruptcy, receiver or liquidator.<sup>44</sup>

Some courts have viewed the monitor as a competent and independent expert providing advice to the court on the merits of the reorganization plan,<sup>45</sup> and another stated that “[t]he monitor must be an agent of the court, it must assist the court and it must be independent of any of the parties.”<sup>46</sup>

This view of the monitor has a number of consequences. First, the monitor can provide evidence by way of report rather than affidavit, and is generally not subject to cross-examination. The courts understandably place great trust and confidence in the information provided by the monitor, and are unreceptive to criticisms or conflicting evidence.

As a result, where the debtor and the monitor are in agreement, debtor’s counsel put in little or no evidence and instead may rely on the monitor’s reports. In practical terms, this makes it very difficult for stakeholders to challenge the debtor’s position.

Second, in their reports monitors now routinely go beyond simply providing information. They will express views and make recommendations to the court concerning matters before the court. Once again, it is difficult for stakeholders to challenge the monitor’s views as an independent expert and officer of the court.

These factors have become increasingly significant as the shape of CCAA proceedings has changed. It used to be that the courts provided a standstill while the principals negotiated. The major commercial transactions were implemented through the plan of arrangement and were therefore subject to prior creditor class approval. In effect, the CCAA operated as a mandatory ADR process that encouraged resolution of business issues through negotiations between the parties whose interests were at stake.

But now major commercial transactions are implemented on an interim basis during the course of CCAA proceedings before a plan is

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<sup>44</sup> *PSINet Ltd., Re* (2002), [2002] O.J. No. 271, 3 P.P.S.A.C. (3d) 208, 30 C.B.R. (4th) 226, 2002 CarswellOnt 211 (Ont. S.C.J. [Commercial List]); affirmed (2002), 32 C.B.R. (4th) 102, 2002 CarswellOnt 619 (Ont. C.A.) at para. 12.

<sup>45</sup> *Canadian Imperial Bank of Commerce v. Quintette Coal Ltd.* (1991), 1991 CarswellBC 457, 53 B.C.L.R. (2d) 34, 1 C.B.R. (3d) 253 (B.C. S.C.).

<sup>46</sup> *Fairview, supra*, n. 32 at para. 75.

filed, with court approval being substituted for creditor approval. This can now extend to transactions as fundamental as a sale of all or substantially all of the business or assets of the debtor.<sup>47</sup>

On application for approval of these transactions, invariably the monitor will file a report and make a recommendation as to whether the proposed transaction should be approved by the court. Almost as invariably, the courts will defer to the monitor's views. Accordingly, in substance these transactions are really subject to monitor approval. As a result the monitor's judgment has replaced the judgment of the court or the creditors.

Monitors can use the threat of withholding their approval to negotiate with the debtor. The debtor knows that, as a practical matter, it will be difficult to obtain court approval for a major transaction without having the monitor's prior approval. So the monitors can and do constructively influence the debtor's conduct. It can therefore be the reality that the real negotiations in the proceedings take place in secret between the monitor and management for the debtor. This has the odd result that one of the key negotiating parties has no direct economic stake in the outcome of the case.

It was the view of the Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals Joint Task Force on Business Insolvency Law Reform (the "JTF") on Independence Issues and the Role of the Monitor, that the monitor must be the "ears and eyes" of the court and that it was critical that the monitor should not be put in a position where it acts as an advocate for the applicants. In its June 30, 2005 Supplemental Report (the "JTF Supplemental Report") to Industry Canada, the JTF stated that:

While it is understood and accepted that in reporting on factual matters, a Monitor will necessarily put forward views – sometimes strong views – on business related matters affecting the applicants, a Monitor should not file a factum or take positions on the legal aspects of any contested issues in the CCAA proceeding. Instead, advocacy of those legal matters should be left to the applicants and any stakeholders who are challenging a position being taken by the applicants.<sup>48</sup>

<sup>47</sup> *Consumers Packaging Inc., Re* (2001), [2001] O.J. No. 3736, 27 C.B.R. (4th) 194, 2001 CarswellOnt 3331 (Ont. S.C.J. [Commercial List]); leave to appeal refused (2001), [2001] O.J. No. 3908, 12 C.P.C. (5th) 208, 2001 CarswellOnt 3482, 27 C.B.R. (4th) 197, 150 O.A.C. 384 (Ont. C.A.).

<sup>48</sup> The Insolvency Institute of Canada and Canadian Association of Insolvency and Restruc-

Based on that principle, the JTF recommended to Industry Canada that the legislation should:

- (a) Provide that the party with the primary obligation to advance a position and adduce evidence before the court should be the applicant and not the Monitor.
- (b) Provide that the Monitor, unless otherwise required by the court, should avoid taking any legal positions or filing a factum regarding contested legal disputes among the parties.
- (c) Provide for an amendment to the *CCAA* section 11.7 to stipulate that the primary roles of the monitor are (a) to monitor the activities of the debtor for the benefit of all interested parties and the court, and (b) to work impartially with the debtor and all interested parties to facilitate the restructuring process.<sup>49</sup>

None of these recommendations were adopted in the *Reform Act*.

#### 4. DEBTOR'S COUNSEL

The professionals retained by the debtor in *CCAA* proceedings, such as counsel for the debtor, play a special role and have a significant impact on the conduct of the proceedings.

Under the U.S. *Bankruptcy Code*, in order for a professional to be retained by the debtor, the professional must submit an application for employment to the court for approval. The statement must describe all interests the attorney has in the case and reveal all relationships the attorney has with the interested parties. The judge then examines the statement and either approves the attorney's retention or disapproves and disqualifies the attorney. The attorney must be "disinterested" and must not hold an "adverse interest" to the estate.<sup>50</sup>

Under the *Bankruptcy Code*<sup>51</sup> to be "disinterested" an attorney must not be a creditor, equity security holder, an insider of the debtor, must not be or have been within two years of the bankruptcy filing, a director, or employee of the debtor, and must not have an interest materially adverse to the interest of the estate, any class of creditors, or equity security holders.

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turing Professionals Joint Task Force on Business Insolvency Law Reform, "Supplemental Report" (June 30, 2005), Schedule S, "Supplemental Reform Proposals With Commentary", at commentary to proposal 18.

<sup>49</sup> *Ibid.*, proposals 17-19.

<sup>50</sup> *Bankruptcy Code*, 11 U.S.C. § 11327.

<sup>51</sup> *Ibid.*, § 11101(14).

One practical consequence of these rules is that Chapter 11 debtors generally hire specialized bankruptcy counsel to act on their behalf. This creates a check and balance on management that does exist in the Canadian system where typically the debtor's primary pre-filing corporate counsel acts as bankruptcy counsel. Until recently there were no rules in Canada's insolvency legislation that attempted to ensure the independence of professionals retained by the debtor, but who act as court officers (such as Monitors) or advisors to court officers.

The JTF Supplemental Report also included recommendations concerning the engagement of certain "specified professionals" in CCAA proceedings designed to address the independence and conflict of interest issues. The JTF was of the view that it is important for the professionals to have a high degree of independence and have the proper professional qualifications.

The JTF recommended that the appointment and retention of a proposed "specified professional" should be confirmed by the court at a confirmation hearing made on notice to all creditors. The JTF defined "specified professionals" to mean professionals retained on behalf of the applicants, as or by an officer of the court (*e.g.*, representative counsel and advisors to official creditor committees), to provide specialized services relating to the proceedings and who are being paid by the estate. Such specified professionals include lawyers, accountants, monitors, chief restructuring officers, trustees, receivers, investment banks, actuaries, and liquidators.

In its Report, the JTF provided the following helpful commentary on the confirmation process:

In determining whether to confirm the appointment of a specified professional, the onus would be on the applicant to satisfy the court that the professional has the appropriate qualifications and can provide independent advice to the party of interest, taking into consideration whether the professional can provide the engagement party with unfettered advice free from any conflicts of influence and whether a professional acting as a court officer can act in an impartial manner with the ability to deal with the rights of all interested parties in a fair and even-handed manner. For example, this would generally preclude a member of historic management acting as a chief restructuring officer of the debtor.

In order to assist the court, the proposed specified professionals would be under a positive duty to disclose certain information to the court, including (i) any work they have done for the applicants within the two (2) years prior to the filing, except as specifically relates to planning for a filing, (ii) any work done on behalf

of any interested party specifically relating to the applicants within the two (2) years prior to the filing (other work done for interested parties is not necessary to disclose), (iii) any work performed on behalf of any parent of any applicant in the two (2) years prior to filing, (iv) any work done on behalf of any subsidiary or sister company of the applicants in the two (2) years prior to the filing and (v) any other matter that might constitute a direct material conflict.

An actual conflict of interest (that includes both any existing conflict or any likely conflict or potentially likely to arise in the course of the administration) should disqualify a specified professional. A perceived conflict of interest should be considered a disqualifying fact only if severe enough to jeopardise the likelihood of the proceedings coming to a reasonable and efficient conclusion or if the perceived conflict of interest is severe enough to place the professional in a position where he cannot work in harmony with the party he is to represent.<sup>52</sup>

The JTF also made recommendations for factors that would not specifically disqualify the professional from acting, but that should be seriously considered by the court. A recommendation was also made that the court should have the power to remove specified professionals at any time. Under the JTF recommendations, the court would have the discretion to sanction payments of fees for services performed by a specified professional in good faith prior to the determination by the court not to confirm the professionals' appointment.

None of the recommendations of the JTF concerning the appointment, retention, and confirmation of professionals found their way into the *Reform Act*. However, the Act does include provisions that attempt to address some issues of independence, requirements, and oversight. The *Reform Act* strengthens the independence of monitors by requiring a monitor to be a trustee within the meaning of the *Bankruptcy and Insolvency Act*, and also requires that during the past two years the monitor did not have connections to the insolvent company, such as acting as a director, officer, or auditor of the company.<sup>53</sup> In addition, Bill C-55 gives the Superintendent of Bankruptcy the right to apply to the court to review the appointment or conduct of a monitor and intervene as if it were a party "in any matter or proceeding in court relating to the appointment or conduct of a monitor."<sup>54</sup>

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<sup>52</sup> *Supra*, n. 48.

<sup>53</sup> *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, s. 129.

<sup>54</sup> *Supra*, n. 1, s. 27.

## 5. CREDITOR VOTING AND CLASSES

A key check and balance on the debtor remains the requirement that the creditors approve a restructuring plan if the debtor itself is to remain the owner of the restructured business. The right of creditors to vote to approve or reject a proposed plan of compromise or arrangement is a foundational element of the CCAA. In that sense, a CCAA restructuring can be, at its core, a fundamentally democratic process.

However, in order to give effect to the democratic ideal and ensure a fair and equitable result, it is necessary to consider and address the potential tyrannies of both majority and minority. The statute seeks to address this, in part, by the division of the creditors into classes. Only the members of the classes that approve the plan in accordance with the double majority test prescribed by the Act are bound by the plan.<sup>55</sup>

Because a different state of facts exists with respect to different creditors which may affect their minds and judgments differently, creditors must be separated into different classes, each of which is comprised of those with common interests.<sup>56</sup> If a class is too broadly defined, a majority may be in a position to approve a plan that is coercive and/or confiscatory of the legal rights voluntarily granted by the applicant to a minority of its creditors.<sup>57</sup> Fragmentation of the creditor group into too many classes may place the success of the plan at risk as members of each class are incentivized to condition their support for the plan on a better deal for their individual class, even at the expense of the odds of a successful restructuring for the benefit of all classes. As a result, the composition of classes under a plan can have a fundamental effect on the voting outcome.

The primary responsibility for making the classification is on the debtor.<sup>58</sup> As the party with the greatest perceived stake in a successful reorganization, the debtor benefits from the broadest possible classifi-

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<sup>55</sup> A plan may be sanctioned by the Court where a majority in number representing two-thirds in value of the voting creditors, or class of voting creditors, approve the plan; CCAA, *supra*, n. 5, s. 6.

<sup>56</sup> *Sovereign Life Assurance Co. v. Dodd* (1892), [1891-94] All E.R. Rep. 246, [1892] 2 Q.B. 573 (Eng. C.A.) [*Sovereign Life*].

<sup>57</sup> *Alabama, New Orleans, Texas & Pacific Junction Railway, Re* (1890), [1891] 1 Ch. 213, 2 Megones Companies Act Cas 377, 7 T.L.R. 171, 64 L.T. 127, [1886-90] All E.R. Rep. Ext. 1143, 60 L.J. Ch. 221 (Eng. C.A.).

<sup>58</sup> *Hellenic & General Trust Ltd., Re* (1975), [1976] 1 W.L.R. 123, 119 Sol. Jo. 845, [1975] 3 All E.R. 382 (Eng. Ch. Div.).

cation of creditors resulting in the fewest number of classes. Accordingly, a question becomes, what legal parameters or guidelines should be applied by the court in order to strike an appropriate balance between, on the one hand, facilitating a successful restructuring for the collective benefit, and, on the other, respect for the unique positions of dissenting creditors.

Prior to the enactment of the amendments to the *CCAA* under the *Reform Act*, the *CCAA* itself did not provide the courts with express guidance as to how as to how to resolve that tension. The courts were left to fill the legislative vacuum with judicially established tests designed to group together creditors with common interests while at the same time seeking to avoid a fragmentation of creditors that would inevitably defeat the plan. The application of the non-fragmentation principal has operated as an exception to the general rule that a court should not comment on a proposed plan prior to approval by the creditors.<sup>59</sup>

The *Reform Act* expressly refers to what has become known as the commonality of interest test and sets out the following four factors to be taken into account by the court when determining whether the interests of creditors are sufficiently aligned to justify inclusion in a common class.

- (a) the nature of the debts, liabilities or obligations giving rise to their claims;
- (b) the nature and rank of any security in respect of their claims;
- (c) the remedies available to the creditors in the absence of the compromise or arrangement being sanctioned, and the extent to which the creditors would recover their claims by exercising those remedies; and
- (d) any further criteria, consistent with those set out in paragraphs (a) to (c), that are prescribed.<sup>60</sup>

The *Reform Act* also codifies the practice of seeking court approval of the applicant's proposed classification of creditors prior to the holding of the meeting of creditors.<sup>61</sup>

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<sup>59</sup> *Sklar-Pepler Furniture Corp. v. Bank of Nova Scotia* (1991), 86 D.L.R. (4th) 621, 8 C.B.R. (3d) 312, 1991 CarswellOnt 220 (Ont. Gen. Div.).

<sup>60</sup> *Supra*, n. 2, s. 71 [amending *Statute c. 47*, s. 131 and *CCAA*, s. 22(2)].

<sup>61</sup> *Supra*, n. 2, s. 71 [amending *Statute c. 47*, s. 131 and *CCAA*, s. 22(1)].

To date, the Canadian courts have established the following as principles to be considered when making an assessment as to commonality of interest:

- (a) Commonality of interest should be viewed on the basis of a non-fragmentation test, not on an identity of interest test.
- (b) The interests to be considered are the legal interests the creditor holds *qua* creditor in relationship to the debtor company, prior to and under the plan as well as on liquidation.
- (c) The commonality of these interests are to be viewed purposively, bearing in mind the object of the CCAA, namely to facilitate reorganizations if at all possible.
- (d) In placing a broad and purposive interpretation on the CCAA, the court should be careful to resist classification approaches which would potentially jeopardize potentially viable plans.
- (e) Absent bad faith, the motivations of the creditors to approve or disapprove are irrelevant.
- (f) The requirement of creditors being able to consult together means being able to assess their legal entitlement as creditors before or after the plan in a similar interest.<sup>62</sup>

The overriding concern that fragmenting the creditors into too many classes may doom the vote on a plan can be discerned in each of the above factors and throughout the jurisprudence on creditor classification. Courts have held that the classification must not be so fine that it renders it impossible to get a plan approved and that a class “must be confined to those persons whose rights are not so dissimilar as to make it *impossible* for them to consult together with a view to their common interests” [emphasis added].<sup>63</sup> The paramount importance placed on the success of the plan can also be seen in the decision of the Ontario Court of Appeal in *Re Stelco Inc.*:

Finally, to hold the classification and voting process hostage to the vagaries of a potentially infinite variety of disputes as between already disgruntled creditors who have been caught in the maelstrom of a CCAA restructuring, runs the risk of hobbling that process unduly. It could lead to the very type of fragmentation

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<sup>62</sup> *Canadian Airlines Corp., Re*, 2000 CarswellAlta 503, [2000] A.J. No. 610, 80 Alta. L.R. (3d) 213, 2000 ABCA 149, 19 C.B.R. (4th) 33, 261 A.R. 120, 225 W.A.C. 120 (Alta. C.A. [In Chambers]); *Stelco Inc., Re* (2005), 15 C.B.R. (5th) 307, 11 B.L.R. (4th) 185, 261 D.L.R. (4th) 368, 78 O.R. (3d) 241, [2005] O.J. No. 4883, 204 O.A.C. 205, 2005 CarswellOnt 6818 (Ont. C.A.), at paras. 23-27; additional reasons at (2006), 2006 CarswellOnt 5194 (Ont. C.A.).

<sup>63</sup> *Sovereign Life, supra*, n. 56 at 583 [Q.B.].

and multiplicity of discrete classes or sub-classes of classes that judges and legal writers have warned might well defeat the purpose of the Act.

In the end, it is important to remember that classification of creditors, like most other things pertaining to the CCAA, must be crafted with the underlying purpose of the CCAA in mind, namely facilitation of the reorganization of an insolvent company through the negotiation and approval of a plan of compromise or arrangement between the debtor company and its creditors, so that the debtor company can continue to carry on its business to the benefit of all concerned. As Paperny J. noted in *Canadian Airlines Corp. Re.*, "the Court should be careful to resist classification approaches that would potentially jeopardize viable plans."<sup>64</sup>

Unfortunately, little is said about the characteristics or qualities of a fair plan or the legitimate expectations of minority creditors. As a result, courts have tended to reject applications by creditors for the establishment of additional classes.

For example, in *Sklar-Pepler Furniture Corp.*,<sup>65</sup> the court rejected an argument by a group of landlords who argued that their interests were sufficiently distinct from those of other unsecured creditors to warrant a separate class. The court held that it would be improper to create a special class simply for the benefit of an opposing creditor that would give that creditor the potential to exercise an unwarranted degree of power, but it did not address the distinction between warranted and unwarranted power. Because the classification of creditors on the basis of identity of interests, as suggested by the landlords, would in some instances result in a multiplicity of classes, which would make any reorganization difficult, if not impossible, neither the realty lessors nor equipment lessors were granted a separate class.

Courts have also expressed concern about the confiscation of legal rights.<sup>66</sup> However, the jurisprudence reflects a reluctance to find a lack of commonality of interest to justify inclusion of creditors in a common class. While it has been held that a bank which has a first claim on accounts receivable and inventory is entitled to be put in a different class from a creditor holding a second claim on those same assets,<sup>67</sup> it has also

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<sup>64</sup> *Stelco Inc., Re* (2005), *supra*, n. 62 at paras. 35-36.

<sup>65</sup> *Sklar-Pepler Furniture Corp. v. Bank of Nova Scotia*, *supra*, n. 59.

<sup>66</sup> *Stelco Inc., Re* (2005), *supra*, n. 62; *Campeau Corp., Re* (1992), [1992] O.J. No. 237, 1992 CarswellOnt 161, 10 C.B.R. (3d) 104 (Ont. Gen. Div.); *Nova Metal Products Inc. v. Comiskey (Trustee of)* (1990), (1990), 1990 CarswellOnt 139, 1 C.B.R. (3d) 101, (sub nom. *Elan Corp. v. Comiskey*) 1 O.R. (3d) 289, (sub nom. *Elan Corp. v. Comiskey*) 41 O.A.C. 282 (Ont. C.A.).

<sup>67</sup> *Campeau Corp., Re, ibid.*

been held that it does not automatically follow that those who have different commercial interests, such as those who hold security on “quick” assets, are necessarily in conflict with those who hold security on hard or fixed assets.<sup>68</sup>

In the result, it appears that the key consideration that informs most classification decisions by the courts is minimizing the risk of the plan not being approved by minimizing the number of creditor classes.

## 6. CREDITORS COMMITTEES

An important check and balance in the U.S. bankruptcy system is the mandatory formation of at least one official creditors’ committee with professional advisors funded by the estate. In Canada there has been considerable hostility towards the concept of official committees, although it is not unusual in larger cases for the debtor to voluntarily fund one or more ad hoc committees.

The Canadian hostility to official committees is rooted in part in the perception that they tend to make restructuring proceedings materially longer and more expensive without adding value to the process. The *Reform Act* does not directly contemplate the formation of creditors’ committees, but arguably it expressly empowers the court to order that the professional costs of a committee be funded by the debtor.

## 7. COURT SANCTION OF A PLAN

A final check and balance in the system is the requirement that the court sanction a plan of reorganization after it has been approved by the creditors. It is helpful to consider the tests for plan sanction in the context of the courts’ overall approach to the *CCAA*.

The *CCAA* is by no means a complete codification of the legal regime under which parties operate in a *CCAA* proceeding. It is more akin to a set of broad guidelines. One reason given for this is that the courts must have the flexibility to address issues as they arise in the “real-time” context of restructurings and should not be bound by an extensive code of rules which would fetter their discretion.

The courts have held that the *CCAA*’s objective is to enable a debtor company to carry on its business in a manner that is designed to cause

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<sup>68</sup> *Fairview Industries Ltd., Re* (1991), 1991 CarswellNS 36, 109 N.S.R. (2d) 32, 11 C.B.R. (3d) 71, 297 A.P.R. 32 (N.S. T.D.).

the least possible harm to itself, its creditors, its employees and former employees and the communities in which it carries on business,<sup>69</sup> but over the years there has been a shift to favour the desire for a successful restructuring rather than protect the interests of creditors and other stakeholders. Part of the reason for this shift has been the argument that Parliament intended for this to be the role of the courts in CCAA proceedings. The formal title of the CCAA is “An Act to facilitate compromises and arrangements between companies and their creditors” and many counsel have used the term “facilitative” to argue that the court has not only the power, but the obligation, to ensure the successful restructuring of a debtor, despite the negative impact this may have on some of the debtor’s stakeholders. As a result, courts have consistently held that the CCAA, as remedial legislation, should be given a large and liberal interpretation so as to encourage and facilitate successful restructurings whenever possible.<sup>70</sup>

In facilitating the achievement of the CCAA’s objectives, courts have relied on their inherent or implied jurisdiction or alternatively, on their broad discretion under section 11 of the CCAA, as the source of judicial power to “fill in the gaps”<sup>71</sup> or “put flesh on the bones” of the statute.<sup>72</sup> This has led not only to an expansive view of the courts’ ability

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<sup>69</sup> *Sklar-Peppler Furniture Corp.*, *supra*, n. 59 at para. 3.

<sup>70</sup> *Hongkong Bank of Canada v. Chef Ready Foods Ltd.* (1990), 1990 CarswellBC 394, [1990] B.C.J. No. 2384, 51 B.C.L.R. (2d) 84, 4 C.B.R. (3d) 311, [1991] 2 W.W.R. 136 (B.C. C.A.) at para. 10 [B.C.L.R.]; *Campeau Corp., Re* (1990), *supra*, n. 66 at para. 22 [C.B.R.]; *Citibank Canada v. Chase Manhattan Bank of Canada* (1991), 4 B.L.R. (2d) 147, 2 P.P.S.A.C. (2d) 21, 5 C.B.R. (3d) 165, [1991] O.J. No. 944, 1991 CarswellOnt 182 (Ont. Gen. Div.) at para. 48; and *Canadian Airlines Corp., Re* (2000), 2000 CarswellAlta 622, 19 C.B.R. (4th) 1 (Alta. Q.B.) at para. 12.

<sup>71</sup> *Royal Oak Mines Inc., Re* (1999), 7 C.B.R. (4th) 293, [1999] O.J. No. 864, 1999 CarswellOnt 792 (Ont. Gen. Div. [Commercial List]) at para. 4.

<sup>72</sup> *Babcock & Wilcox Canada Ltd., Re* (2000), (2000), 2000 CarswellOnt 704, [2000] O.J. No. 786, 18 C.B.R. (4th) 157, 5 B.L.R. (3d) 75 (Ont. S.C.J. [Commercial List]); *Canadian Red Cross Society / Société Canadienne de la Croix-Rouge, Re* (1998), 1998 CarswellOnt 3346, [1998] O.J. No. 3306, 5 C.B.R. (4th) 299, 72 O.T.C. 99 (Ont. Gen. Div. [Commercial List]); additional reasons at (1998), 1998 CarswellOnt 3347, 5 C.B.R. (4th) 319 (Ont. Gen. Div. [Commercial List]); additional reasons at (1998), 1998 CarswellOnt 3345, 5 C.B.R. (4th) 321 (Ont. Gen. Div. [Commercial List]); leave to appeal refused (1998), 1998 CarswellOnt 5967, 32 C.B.R. (4th) 21 (Ont. C.A.); *Dylex Ltd., Re* (1995), [1995] O.J. No. 595, 1995 CarswellOnt 54, 31 C.B.R. (3d) 106 (Ont. Gen. Div. [Commercial List]); *Re Royal Oak Mines Inc.* (1999), *supra*, n. 71; *MEI Computer Technology Group Inc., Re*, [2005] Q.J. No. 5744, EYB 2005-90239, [2005] R.J.Q. 1558, 2005 CarswellQue 3675, 19 C.B.R. (5th) 257 (Que. S.C.) at para. 20.

to work around the few legal tests that are codified in the *CCAA*, but to grant a broad range of relief that is not provided for.

Once the creditors have approved the plan, a hearing is held for the court to sanction it. There is no explicit test set out in the *CCAA* for the sanctioning of a plan, but the courts have developed a test which provides that a plan will be sanctioned if (a) there has been compliance with all statutory requirements and orders, (b) nothing has been done or purported to be done that is not authorized by the *CCAA*, and (c) the plan is “fair, reasonable and equitable.”<sup>73</sup>

As a practical matter, in most cases it is the third branch of the test that is in issue if there is a serious contest over the sanctioning of a *CCAA* plan. In determining whether a plan is fair and reasonable, the court will take into consideration the impact of the plan upon all the interested parties including creditors and shareholders. Despite the discretion afforded to the court in sanctioning the final plan, case law has generally established that where the required majorities have approved the plan, the court should hesitate to substitute its view of what is fair and reasonable for that of those affected by the plan. In *Olympia & York Developments Ltd. v. Royal Trust Co.*, it was stated that an important measure of whether a plan is fair and reasonable is the parties’ approval of the plan and the degree to which the approval has been given.<sup>74</sup> In *Repap British Columbia Inc., Re*, the British Columbia Supreme Court even went so far as to state that even if the court is unable to find that the plan is fair and reasonable, if a large majority of creditors have approved it, the court may still sanction it.<sup>75</sup> What is fair and reasonable does not mean equal to all,<sup>76</sup> the plan need only achieve a compromise which is fair, reasonable, and feasible.<sup>77</sup>

In light of this, the burden of a creditor requesting that the court not sanction a plan that has been approved by the majority of creditors is very heavy.

<sup>73</sup> *Sammi Atlas Inc., Re* (1998), 3 C.B.R. (4th) 171, 1998 CarswellOnt 1145, [1998] O.J. No. 1089 (Ont. Gen. Div. [Commercial List]).

<sup>74</sup> (1993), 1993 CarswellOnt 182, [1993] O.J. No. 545, 17 C.B.R. (3d) 1, (sub nom. *Olympia & York Developments Ltd., Re*) 12 O.R. (3d) 500 (Ont. Gen. Div.).

<sup>75</sup> (1998), 1998 CarswellBC 42, 50 B.C.L.R. (3d) 133, 1 C.B.R. (4th) 49 (B.C. S.C.).

<sup>76</sup> *Wandlyn Inns Ltd., Re* (1992), 1992 CarswellNB 37, 15 C.B.R. (3d) 316 (N.B. Q.B.).

<sup>77</sup> *T. Eaton Co., Re* (1999), (1999), 15 C.B.R. (4th) 311, 1999 CarswellOnt 4661, [1999] O.J. No. 5322 (Ont. S.C.J. [Commercial List]).

## 8. CONCLUSION

Over the last 25 years or so the Canadian business insolvency system has moved away from focusing on sale proceedings conducted principally for the direct benefit of creditors. It now focuses on reorganization proceedings controlled by the debtor. There are clear potential advantages to this shift.

In order for debtors to be able to reorganize, they have to have extraordinary powers or tools that would not be available to them outside of an insolvency proceeding. In Canada, many of these extraordinary powers or tools were first authorized by the exercise of judicial discretion rather than as a result of legislative reform. In a sense, the *Reform Act* completes the process of empowering debtors by expressly conferring the extraordinary tools developed in the courts.

However, this shift has created a vacuum. The *Reform Act* contains no direct guidance on the question of how the debtor should decide to use its extraordinary powers. As a result, by default the courts look to applicable corporate law. However, Canada's corporate laws were developed for solvent entities acting without the extraordinary powers that are now available in insolvency proceedings. The corporate laws do not in substance provide any real guidance about how and why the extraordinary tools available to a debtor in insolvency should be used.

The courts have shied away from policing the exercise of those extraordinary powers and have proactively limited the role of the creditors in restructuring proceedings, fearing that empowering the creditors would tend to put the "success" of the restructuring proceedings at risk.

Court appointed monitors have influence over debtors, but monitors are hired by the debtor and have no direct economic stake in the process. There are material limits upon what can be fairly expected of monitors given the underlying foundations of their role.

The cumulative effect of these various factors is that Canada now has a system that encourages reorganizations by the debtor but has few meaningful checks and balances. It is hard to see when a court should say no to a debtor if it has the jurisdiction to say yes.

During the statutory reform process suggestions for creating various checks and balances in the system were advanced but not adopted.

In fact, the *Reform Act* itself provides little guidance about how the debtor is to use its new powers.

It is clear that the implications of this result have not been weighed in the balance. Unless one believes that any “restructuring” is inherently better than the alternatives, there are good reasons to be concerned about these implications.