Rescue! The Companies' Creditors Arrangement Act

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CHAPTER 1

INTRODUCTION AND OVERVIEW OF THE *CCAA*

I. INTRODUCTION

The *Companies' Creditors Arrangement Act (CCAA)* is an extraordinary Canadian statute.[1] Extremely short in length, only 22 provisions, it is one of the enabling tools to allow insolvent companies to restructure. It has been the statute of choice for debtor corporations in every major restructuring in the past quarter century, including national airlines, major steel and forestry companies, telecommunications companies and the national blood delivery system. The statute's full title, *An Act to Facilitate Compromises and Arrangements between Companies and Their Creditors,* precisely describes its purpose; providing a court-supervised process to facilitate the negotiation of compromises and arrangements where companies are experiencing financial distress, in order to allow them to devise a survival strategy that is acceptable to their creditors.

While there is no official database, a recent empirical study by the author has found that there have been 254 cases under the *CCAA*, the overwhelming majority of these in the past 20 years.[2] Of those cases, the majority were privately held companies.

CCAA proceedings can involve a broad range of workout options. The going forward solution to the firm's financial distress depends on the reason for the insolvency, the firm's capital structure, the viability of its business plan and effectiveness of its governance structure. One could broadly categorize financial distress in two ways.

In the first category, the debtor corporation may have used its assets efficiently, but a temporary downturn in the market or unforeseen liquidity crunch has precipitated the insolvency. Similarly, the debt/equity ratio decided on by corporate officers for one type of market may no longer be sustainable with unforeseen capital market changes. In such cases, the best option may be to devise a plan that allows the firm to keep operating for a period, where there is a current or expected future market

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[1] *Companies' Creditors Arrangement Act,* R.S.C. 1985, c. C-36, as amended (*CCAA*).

[2] Janis Sarra, UBC *CCAA Empirical Study*, data on file with author, funded by the Social Sciences and Humanities Research Council of Canada.

for its output. Hence, it is essential to understand the particular market in which the debtor is operating.

In the second category, the problem is one of governance, such as management's failure to respond adequately or in a timely manner to capital market changes or failure to develop and implement a viable business plan. Financial decisions, such as borrowing on a short-term basis that has negative long-term consequences, or cost overruns on plant expansion can also account for the firm's financial distress. The insolvency has often signalled inefficient use of assets or managerial slack or incompetence. A firm can be inefficient, and the optimal strategy is to continue operating, but to radically change the governance practices to generate value for the firm. The debtor may need to change how it achieves efficiency, including improving productivity, implementing better decision making and oversight structures, and shifting its labour/management relationships from confrontational to co-operative in order to have all stakeholders committed to a long-term survival strategy for the firm. When the firm is economically inefficient and change in governance will not remedy its financial distress, the best outcome may be to liquidate or sell the business as a going concern and release the capital to higher value uses. It avoids the further erosion of capital if losses are projected over the long term.[3] Often there is a combination of governance and market factors that have led to the insolvency.

As with all commercial economies, Canada's statutory framework creates a hierarchy of claims to the corporation's assets. Secured creditors, subject to very limited exceptions, generally have first claim on the assets when a firm is insolvent. In contrast, shareholders' equity claims have little or no value. Hence, during firm financial distress, it is the senior secured creditors that are the parties largely driving the process, although directors and officers may remain in place for a period of time during the negotiations for a going forward business plan. While directors continue to have an obligation to act in the best interests of the corporation, commercial reality dictates that they must be sensitive to the demands of secured creditors or the process will fail and the business will be liquidated. How those interests are thus reconciled with other stakeholders such as employees, trade suppliers, customers and the community as a whole is one of the key challenges for insolvency proceedings.

While the debtor and its advisors need to have a clear understanding of the source of the debtor corporation's financial distress if there is to be a viable workout, this information is not used to assign blame under the *CCAA*. Rather, it provides important information to determine the operational or other changes that may be required to allow the debtor corporation to make its business viable and devise a business plan that can garner the requisite creditor support.

Hence, a *CCAA* restructuring proceeding is a step to avoid bankruptcy. In bankruptcy, the assets of a company vest with a trustee in bankruptcy, who is an insol-

[3] Janis Sarra, "Governance and Control: The Role of Debtor-in-Possession Financing under the *CCAA*", in J. Sarra, ed., *Annual Review of Insolvency Law, 2004* (Toronto: Carswell, 2005) 119–172.

vency professional that liquidates the assets and distributes the proceeds among creditors according to the priority of their claims, as set out in the *Bankruptcy and Insolvency Act (BIA)*.[4] The company could still be sold as a going concern, although it is the trustee that has carriage of the process, not the directors and officers. Insolvency and bankruptcy law is aimed at allocating decision and control rights in the financially distressed corporation to ensure optimal use of the assets, whether the ultimate disposition is continuation of the business, sale as a going concern and/or liquidation.[5]

Where an insolvent corporation's business is viable, the *CCAA* provides an opportunity for the debtor corporation to negotiate a workout with its creditors, either through compromises of the amount of claims owing or timing of payments, refinancing agreements, conversion of debt to equity, or the injection of new equity investment in the firm. Restructuring can result in arrangements that are a hybrid of these strategies, such as liquidation on a going-concern basis or liquidation of part of the business in order to finance restructuring of the rest of the enterprise and dispose of underperforming assets, or a mix of liquidation and going forward business, which the courts have approved in appropriate circumstances.[6] A business is frequently worth more as a going concern than if its assets are liquidated on a piecemeal basis to satisfy creditors' claims.

Where a debtor corporation can restructure, preservation of ongoing value, such as the skilled workforce, supply arrangements, customer base and other goodwill, adds extra value over and above the aggregate value of individual hard assets. Alternatively, sale of the enterprise on a going-concern basis to third parties may be the solution, especially if the new owner brings operational expertise, management skills, liquidity, access to reserve capital, and other benefits to the business. The court-supervised process assists with controlling and allocating the collective action and transaction costs among the firm's diverse creditors, thus ensuring more value is extracted from the firm.[7]

While Canada's insolvency system historically favoured liquidation of firms that were unable to meet their debts as they generally became due, the system has shifted to more of a rehabilitation system, although there continues to be a fair degree of control by senior lenders. Canada's regime shifted towards a rehabilitation model

[4] *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (*BIA*). The *BIA* also contains restructuring provisions, discussed below.

[5] G. Triantis, "The Interplay Between Liquidation and Reorganization in Bankruptcy, The Role of Screens, Gatekeepers and Guillotines" (1996) 16 Int. Rev. Law & Economics 101 at 103.

[6] *Anvil Range Mining Corp., Re* (2002), 34 C.B.R. (4th) 157 (Ont. C.A.), additional reasons at (2002), 38 C.B.R. (4th) 5 (Ont. C.A.), leave to appeal refused (2003), 2003 CarswellOnt 730 (S.C.C.).

[7] Thomas Jackson, "Translating Assets and Liabilities in the Bankruptcy Forum" and the Hon. Richard Posner, Chief Judge, U.S. Court of Appeals for the Seventh Circuit, "Foreword", both in J.S. Bhandari and L.A. Weiss, eds., *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge: Cambridge University Press, 1996) at xi. 53. Lynn LoPucki and George Triantis, "A Systems Approach to Comparing U.S. and Canadian Reorganization of Financially Distressed Companies" in Jacob Ziegel, ed., *Current Developments in International and Comparative Corporate Insolvency Law* (Oxford: Clarendon Press, 1994) at 109.

almost a decade earlier than nations such as the United Kingdom or Germany, which are now moving from liquidation to reorganization as a key focus of the insolvency system. This global context is important, because, as will be seen throughout this book, there is pressure for the system to change once again, given the control shifts in international capital markets in terms of the nature and type of lenders that increasingly dominate capital markets. The most recent changes raise new public policy challenges for an effective restructuring system.

Insolvency law is an indispensable component of commercial economies and regulates governance of the insolvent corporation during the key period of decision-making regarding its future. Insolvency law also plays a broad social and economic role in overall economic planning; the survival of financially distressed firms and the economic activity that they generate are in themselves important objectives of the system.[8] However, rehabilitation of the firm can only occur where a business is viable, and there may be some industries in which current capacity must be rationalized. Globalization pressures make these determinations complex, because the decision is layered with whether there is a national interest in preserving particular types of economic activity within Canada or whether the assets should be put to their highest use elsewhere.

There can also be public policy issues associated with allowing one corporation to shed its debt and reorganize, creating a somewhat competitive advantage over corporations in the same market that were competitive until the debtor went through reorganization, down-sized or took other measures, free of the costs normally imposed on such activities by contractual and regulatory obligations. Workouts that provide an advantage to one party to the detriment of more vulnerable parties can create a downward spiral of economic activity in a particular sector. Arguably, the goal of the insolvency system is to maximize the value of the enterprise overall; and where firms can generate more value for stakeholders on a going-concern basis, the insolvency system should facilitate the debtor corporation's negotiation with creditors for a viable plan of arrangement.[9] Equally, however, one needs to be cognizant of the overall impact on a particular sector where one major corporation has restructured when the entire sector is in a struggle to survive.

1. The *CCAA* in the Context of the Canadian Insolvency System

There are currently three principal insolvency statutes in Canada, which together provide a regime that deals with insolvency of individuals and companies, the *Companies' Creditors Arrangement Act*, the *Bankruptcy and Insolvency Act* and the *Winding-up and Restructuring Act*.[10] Also significant are the arrangement provisions

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[8] Karen Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* (New Haven: Yale University Press, 1997).

[9] Janis Sarra, *Creditor Rights and the Public Interest, Restructuring Insolvent Corporations* (Toronto: University of Toronto Press, 2003).

[10] *Winding-up and Restructuring Act*, R.S.C. 1985, c. W-11, as amended.

of federal, provincial and territorial corporations statutes. Other mechanisms to deal with firm financial distress are receiverships under provincial courts of justice statutes, and remedies that arise out of secured transactions under provincial and territorial personal property security statutes.[11] There are also provincial and territorial statutes that deal with fraudulent conveyances, assignments and preferences, which can be accessed as a means to enforce creditor claims when a firm is in financial distress.[12] The discussion in this part confines itself only to the first four of these options.

The *Bankruptcy and Insolvency Act (BIA)* addresses both individuals and companies, and provides a mechanism for assigning or petitioning financially troubled debtors into bankruptcy and liquidating their assets, as well as providing a series of interim mechanisms such as appointment of receivers to take conservatory and other measures for the protection of creditors.[13]

When a corporation is insolvent, there are remedies available to creditors. The insolvency scheme provides that secured creditors can privately enforce their claims by meeting statutory and common law requirements of demand, reasonable notice and notice of intention to enforce security.[14] Once these are met, the creditor can privately appoint or seek a court appointment of a receiver to realize on the property securing its claims. A creditor falls within the scope of the *BIA* enforcement provisions if the debtor is "insolvent" within the meaning of the statute and the collateral being enforced against by the secured creditor constitutes all or substantially all of a category of the debtor's assets. The *BIA* defines an "insolvent person" as one who has debts exceeding $1,000, is unable to meet obligations or has ceased paying them in the ordinary course of business as they generally become due, or the aggregate of whose property is not, at fair valuation, sufficient, or if disposed of at a fairly conducted sale under legal process would not be sufficient to enable payment of all obligations due and accruing due.[15]

The *BIA* is aimed at bringing uniformity to the administration and liquidation of bankrupt estates in Canada. The underlying principle is that creditors should control administration of the assets of the corporation that has been placed into bankruptcy, because liquidation is for the almost exclusive benefit of the creditors and they are in the best position to determine what is in their interests. The *BIA* sets a hierarchy for the satisfaction of claims.[16]

[11] See for example, Ontario *Courts of Justice Act*, R.S.O. 1990, c. C. 43, s. 101; Alberta *Personal Property Security Act*, R.S.A. 2000, c. P-7, s. 66; Nova Scotia *Personal Property Security Act*, S.N.S. 1995-96, c. 13, s. 66.

[12] For a helpful introduction to these other remedies on insolvency, see Kevin McElcheran, *Commercial Insolvency in Canada*, (Toronto: LexisNexis Canada Inc., 2005).

[13] *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (*BIA*).

[14] Section 244, *BIA*.

[15] Section 2(1), *BIA*.

[16] This hierarchy interacts with other statutes, such as the *Bank Act*, section 427; see also provincial statutes such as the *Personal Property Security Act*.

In addition to the mechanisms outlined in the *BIA* addressing the realization of property of a debtor and the distribution thereof to the creditors according to their relative rights, the *BIA* also provides a scheme for commercial "proposals", in order to allow an insolvent person or a bankrupt an opportunity to restructure its affairs and become financially viable.[17] As with the *CCAA* process, the proposal process allows a brief reprieve in which the *status quo* is maintained and creditors' realization rights are temporarily suspended. Proposal is defined in the *BIA* as including a proposal for a composition, where creditors agree to accept less than full repayment or an extension of time; and/or a scheme of arrangement in terms of alteration of debt and equity structure.[18] Corporate officers retain control of the corporation's assets and operations, and the trustee that assists with development of the proposal acts in a monitoring and advisory capacity, as opposed to taking over control of the company. The *BIA* proposal proceedings are used for individuals and for all sizes of business, from sole proprietorships to larger corporations. The greatest challenge for using the *BIA* as the tool to rescue a financially distressed company, however, is its "sunset clause"; specifically, failure to negotiate and receive creditor support for, and the sanction of the court of, a proposal within six months results in the company automatically becoming bankrupt. There is no judicial discretion to extend the stay past six months. This is discussed further below.

The second statute is the *Companies' Creditors Arrangement Act (CCAA)*, which allows corporations to negotiate a plan of arrangement or compromise with their creditors, as discussed in the introduction.[19] The *CCAA* is available to debtor corporations that are insolvent or bankrupt and have debts greater than $5 million.[20] Both the *BIA* proposal provisions and the *CCAA* allow for compromise of claims of both secured and unsecured creditors. Any reorganization of the equity of the corporation requires concurrent proceedings under corporations statutes.[21] Section

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[17] Section 50, *BIA*. The *BIA* provides that a proposal may be made by an insolvent person and a bankrupt, as well as by various persons on behalf of the insolvent person or bankrupt. For ease of reading, the remainder of this text refers only to a proposal being filed by an insolvent person, and the reader should understand that the provisions apply equally to the other situations, unless specifically stated otherwise. Refer also to section 2 of the *BIA* for the definitions of "person", "insolvent person" and "corporation". In effect, the *BIA* applies to a wide category of debtors, whether the debtor is an individual, partnership, corporation, cooperative society, association, etc., excluding banks, insurance companies, trust companies, loan companies and railway companies.

[18] Section 2(1), *BIA*. *Mutual Trust Co.* v. *Scott, Pichelli & Graci Ltd.* (1999), 11 C.B.R. (4th) 54 (Ont. Bktcy.), additional reasons at (1999), 11 C.B.R. (4th) 62 (Ont. Bktcy.).

[19] *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended (*CCAA*).

[20] Section 2, *CCAA*. The *CCAA* specifies that a debtor company may be a company that is insolvent or bankrupt. The distinction as relates to proceedings in respect of a bankrupt are found in section 11.6 of the *CCAA*. This section provides that a bankrupt can avail itself of the provisions of the *CCAA* only in the situation where the bankruptcy does not result from a failed restructuring proceeding under the *BIA*, and then only with the prior approval of inspectors appointed to the estate. The remainder of the text refers only to a plan of arrangement being filed in respect of an insolvent person, and the reader should understand that the comment applies equally to a bankrupt, unless specifically stated otherwise.

[21] Once Chapter 47 is proclaimed in force, this will no longer be a requirement. *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*, S.C. 2005, Chapter 47, Royal Assent November 25, 2005, not yet proclaimed in force as of December 2006.

8 of the *CCAA* specifies that the *Act* has full force and effect notwithstanding anything to the contrary contained in a security interest; hence parties cannot contract out of the *CCAA* provisions.[22] Whereas the *BIA* is highly codified, the *CCAA* is a skeletal statute. The scope and contours of the *CCAA* have been set through the caselaw, with the court acting in a supervisory capacity during the period that parties negotiate a workout strategy and business plan.

The third insolvency statute is the *Winding-up and Restructuring Act (WURA)*, which covers financially distressed financial institutions and certain corporations and allows such persons to be liquidated or restructured.[23] Finally, there is the *Farm Debt Mediation Act*, enacted to help farmers in financial distress by allowing them to seek relief from secured and unsecured debt in particular circumstances.[24]

There are also private workouts that are undertaken without the benefit of any statutory mechanism. An insolvent corporation can restructure its affairs through a private arrangement with its creditors, which may be possible if there are few creditors or it is a closely held company where there is some ability to deal with equity and debt claims for only a few stakeholders. Use of a private workout does not necessarily signal to consumers or trade suppliers that the corporation is in difficulty and may facilitate the retention of key employees and distributors who might otherwise begin diversifying their risk by seeking employment or contracts elsewhere.[25] Generally, private workouts with a few creditors are cheaper and faster than court-supervised processes, in part, precisely because there are fewer creditors and thus fewer transaction costs and collective action problems in the negotiations for a workout.

However, private workouts are rarely a practical solution, except in special circumstances. The characteristics of an efficient restructuring tool include the ability to suspend recourse against the debtor while the discussions are progressing, and the ability to force a minority of creditors to be bound by an agreement acceptable to the majority. Under the *BIA* and the *CCAA*, the debtor need only win the support of a majority in number representing two thirds in value of claims in each class of creditors, present or represented at the meeting, in order to meet the statutory requirements for a proposal or plan; hence the debtor can deal with "holdout creditors", who will not agree to a plan or will agree only if they receive payment in full. This ability to deal with holdout creditors is not possible under a private workout. In other words, the stay under the *BIA* or *CCAA* creates the potential ability to compel creditors to act collectively rather than individually. In many cases of cor-

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22 *Hongkong Bank of Canada* v. *Chef Ready Foods Ltd.* (1990), 4 C.B.R. (3d) 311 (B.C. C.A.).

23 *Winding-up and Restructuring Act*, R.S.C. 1985, c. W-11 (*WURA*). For example, by virtue of section 3(3) of the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, as amended *(CBCA)*. The *WURA* does not apply to corporations incorporated under the *CBCA*.

24 *Farm Debt Mediation Act*, S.C. 1997, c. 21. This Act is essentially a voluntary mediation act, but since it has no mechanism to bind creditors who do not agree with a proposed arrangement, its utility is limited.

25 Janis Sarra, *Creditor Rights and the Public Interest, Restructuring Insolvent Corporations* (Toronto: University of Toronto Press, 2003).

porate insolvency, there are hundreds and sometimes thousands of creditors, and thus a private workout is not possible. Given that creditors are not prevented from seeking to enforce their claims during negotiation for a private workout, debtor corporations often seek the protection of court-supervised processes.[26] For companies with a number of creditors or any complexity in the debt structure, the provisions under both the *BIA* and the *CCAA* that stay creditors' ability to realize on their claims for a period, provide a breathing space to corporations so that they can negotiate a workout plan with creditors.

A less commonly used means of restructuring than the *BIA* or *CCAA* is use of the arrangement provisions under the *Canada Business Corporations Act (CBCA)* and companion provincial and territorial corporations statutes, where at least one corporation in a group of affiliated companies that are trying to restructure is solvent, even if the principal company in the corporate group is itself insolvent.[27] The principal reason for using the *CBCA* or other corporations statutes is to preserve equity for shareholders. A precondition to use of the *BIA* or *CCAA* is that the corporation is insolvent and thus there is little or no equity remaining in the corporation.

In contrast, the arrangement provisions of the *CBCA* require the corporation to be solvent, and thus can be used to try to preserve shareholder equity as well as value for creditors.[28] For example, in *Dome Petroleum*, Dome was insolvent yet the proposed arrangement required amalgamations and debt exchanges, neither easily provided for under the *CCAA*, even if the application had been brought conjointly with a *CBCA* application.[29] Amoco Acquisitions, a solvent corporation, applied to the court under the *CCAA* and received a declaration from the Alberta Court of Queen's Bench that its proposed arrangement was an arrangement pursuant to the *CBCA* and that the court had jurisdiction. It then proceeded to secure the support of creditors and shareholders, and the endorsement of the court to amalgamate with Dome and several other subsidiaries. The Court thus facilitated the plan of arrangement by liberally interpreting the arrangement provisions of the *CBCA*, by finding at least one company solvent within a group of affiliated companies seeking to utilize the corporations statute to effect a restructuring.

As this book goes to press, it is important to note that legislative reform has been proposed. Chapter 47 of the Statutes of Canada, 2005, amending the *CCAA* and the *BIA* and creating a new national wage earner protection program, has been enacted

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26 *Ibid.*

27 *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, as amended (*CBCA*). For an example of provincial provisions, see Ontario *Business Corporations Act*, R.S.O. 1990, c. B. 16, section 186; and Alberta *Business Corporations Act*, R.S.A. 2000, c. B-9, s. 192.

28 See for example, the cases of *Dome Petroleum* and *Unitel Communications* in J. Ziegel and D. Baird, eds., *Case Studies in Recent Canadian Insolvency Reorganizations. In Honour of the Honourable Lloyd W. Houlden* (Toronto: Carswell, 1997).

29 Simon Scott, "The Acquisition of Dome Petroleum Limited by Amoco Corporation" in Ziegel and Baird, *ibid.* at 300, citing unreported judgment, *Amoco Canada Petroleum Co. v. Dome Petroleum Ltd.* (January 28, 1988), Doc: Calgary 8701-20108 (Alta Q.B.) at 311, 313.

but has not yet been proclaimed in force.[30] Subsequent to the legislation receiving Royal Assent in November 2005, there was a federal election in Canada and the Liberal government was replaced by a Conservative government. The new Government is expected to bring further amendments forward early in 2007 prior to proclaiming Chapter 47 in force.[31] There are references throughout this book to the proposed changes to the *CCAA* under Chapter 47.

2. Policy Objectives of the *CCAA*

The *CCAA* has a broad remedial purpose, permitting compromises or arrangements to be made between an insolvent company and its creditors. The courts have held that the *CCAA* allows the debtor company to avoid bankruptcy, to continue operating, and to find a business strategy that enables it to meet the demands of creditors.[32] The *CCAA* is to be given a large and liberal interpretation so as best to meet its policy objectives.[33]

Canadian courts have held that the *CCAA* is aimed at avoiding, where possible, the devastating social and economic consequences of the cessation of business operations, and at allowing the corporation to carry on business in a manner that causes the least possible harm to employees and the communities in which it operates. There is a public policy interest in allowing for a certain transition period to allow debtors to economically adjust in difficult markets in unsettled times; and the courts have held that co-operation is required if the debtor corporation is to emerge competitive, innovative, and able to withstand temporary adversity.[34] The costs of the process are outweighed by the benefits of potential success and the protection of multiple interests. The Alberta Court in *Fracmaster* held that the objective of the

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[30] *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*, S.C. 2005, Chapter 47, Royal Assent November 25, 2005, not yet proclaimed in force as of December 2006 (Chapter 47). On December 8, 2006, the Government gave notice of further amendments under the *Notice of Ways and Means Motion to introduce an Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earners Protection Act and Chapter 47 of the Statutes of Canada, 2005*, (December 8, 2006, Library of Parliament), which are primarily in the nature of administrative amendments to Chapter 47 to clarify language or align the provisions of the *CCAA* more directly with the companion provisions of the *BIA*. However, the amendments have not yet been tabled as of December 31, 2006.

[31] Current projections are that Chapter 47 may come into force in 2007 (Industry Canada, Policy Branch).

[32] *Multidev Immobilia Inc.* v. *S.A. Just Invest*, (1988), 70 C.B.R. (N.S.) 91, [1988] R.J.Q. 1928 (Que. S.C.); *Meridian Development Inc.* v. *Toronto Dominion Bank* (1984), 52 C.B.R. (N.S.) 109, 32 Alta L.R. (2d) 150 (Alta. Q.B.).

[33] *Nova Metal Products Inc.* v. *Comiskey (Trustee of)* (1990), 1 C.B.R. (3d) 101, (sub nom. *Elan Corp.* v. *Comiskey*) 1 O.R. (3d) 289 (Ont. C.A.); *Citibank Canada* v. *Chase Manhattan Bank of Canada* (1991), 5 C.B.R. (3d) 165 (Ont. Gen. Div.).

[34] *Algoma Steel Inc., Re* (2001), 2001 CarswellOnt 4640, [2002] O.J. No. 66, 30 C.B.R. (4th) 1 (Ont. S.C.J. [Commercial List]), LeSage, C.J.S.C. at para. 8; *Sammi Atlas Inc., Re* (1998), 3 C.B.R. (4th) 171 (Ont. Gen. Div. [Commercial List]), at 173-4.

CCAA to facilitate restructuring should include consideration of interests beyond those of senior creditors.[35]

The *CCAA* was enacted in 1933, but was really only rediscovered as a valuable restructuring tool in the past 25 years. The *CCAA* has the simultaneous objectives of maximizing creditor recovery, preservation of going concern value where possible, preservation of jobs and communities affected by the firm's financial distress, rehabilitation of honest but unfortunate debtors, and enhancing the credit system generally.[36] These objectives can be measured by whether production has been maximized; whether there is a resultant generation of consumer surplus and overall welfare of the enterprise; whether the corporation has provided opportunities for workers to remain productive; whether a greater flow of profits to investors has been generated than would occur if they invested elsewhere; and whether the flow of benefits and size of return to suppliers and other creditors is such that this is optimal use of their capital and supplies, rather than directing their resources elsewhere.[37] A workout can be effective where these complex relationships interact in a cost effective, productive, and innovative manner.

One measure of a successful *CCAA* workout is the financial health of the corporation some years later. However, the nature of restructuring proceedings is shifting, such that the longer term financial health and wealth generating activity of the debtor may no longer be the only measure of a successful *CCAA* application. Although the public policy objectives of the statute remain the same, there are new actors entering the market and new efforts at controlling the process and outcome of a *CCAA* proceeding, such that these public policy goals may be at some risk. This is most evident in the discussion of DIP financing in chapter 4, but is highlighted throughout this text.

Notwithstanding the success of the *CCAA* in meeting its legislative objective of facilitating plans of arrangement and compromise with creditors, the statute is not without its critics. The skeletal nature of the statute means that the supervising judge is required to make numerous procedural and substantive decisions during the *CCAA* proceedings. There has been some criticism that this leaves judges with too much discretion and parties with too much uncertainty.[38] U.S. lenders, who often supply capital for a restructuring, are accustomed to a highly rules-based lending environment during insolvency and frequently are concerned about the lack of codification under the *CCAA*.

However, as will be discussed in chapter 3 on the role of the courts, examination of the caselaw reveals that the role of judges is twofold: supervising the proceedings

[35] *Fracmaster Ltd., Re* (1999), 11 C.B.R. (4th) 204 (Alta. Q.B.), Paperny, J., affirmed *Royal Bank* v. *Fracmaster Ltd.* (1999), 11 C.B.R. (4th) 230, 1999 ABCA 178 (Alta. C.A.) at paras. 18-23.

[36] For a discussion, see Janis P. Sarra, *Creditor Rights and the Public Interest. Restructuring Insolvent Corporations* (Toronto: University of Toronto Press, 2003).

[37] Margaret Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (Washington, DC: Brookings Institute, 1995) at 240.

[38] Andrew Kent, "Comment on Professor Yamauchi's Paper" (2004) 40 Canadian Business L.J. 295.

and weighing the prejudice to parties of particular decisions, and tempering the activities of the most aggressive and powerful parties in the restructuring process. The *CCAA* is a statute that facilitates bargaining. However, that bargaining occurs in light of radically different economic stakes in the financially distressed company, unequal bargaining power, and frequently, information asymmetries. While it is not realistic to expect a level playing field in a *CCAA* workout, the court's role in balancing interests and prejudice has become an extremely significant one.

As will be seen throughout this text, Parliament has addressed the uncertainty question in its proposed amendments to the *CCAA* in Chapter 47. A number of current practices of the court will be codified for the first time, enhancing the transparency of particular rights and remedies in such proceedings, and arguably creating greater certainty in some cases. At the same time, Parliament has chosen to leave a fair degree of discretion with the court in its exercise of jurisdiction under the *CCAA*.

3. Policy Instruments

The primary instrument under the *CCAA* is to grant a stay of proceedings against the debtor corporation so that it has breathing room to develop a going forward business and financial plan with its creditors. The *CCAA* maintains the *status quo* in terms of the debtor's financial relationships for the period of the stay, while the debtor corporation negotiates with creditors and seeks approval for a plan that will allow it to continue operating.[39] It provides a structured environment in which the debtor corporation can carry on business and retain control over assets during the negotiations.[40] The courts have also held that a public policy objective is to permit a broad balancing of stakeholder interests in the insolvent corporation.[41]

One of the objectives of an efficient insolvency system is that it discourages both premature liquidation and deferred liquidation. Premature liquidation arises because over-caution by directors and officers in respect of their own liability risk leads to filing of bankruptcy prematurely, or creditors move to enforce their claims on all or substantially all of the assets without a prior determination of whether there is going concern value in the enterprise. The *CCAA* provides debtors with a tool to act prior to this point as it provides a stay of proceedings without having to become bankrupt and the temporary stay allows for negotiations with creditors who might otherwise enforce their claims and prematurely insist that assets be liquidated.[42] Deferred liquidation is where directors and officers have not acted in a timely manner to deal with the firm's financial distress, specifically, to file under the *CCAA* or under the

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39 *Quintette Coal Ltd.* v. *Nippon Steel Corp.* (1990), 80 C.B.R. (N.S.) 98 (B.C. S.C.).

40 *Blue Range Resource Corp., Re* (2000), 192 D.L.R. (4th) 281, 20 C.B.R. (4th) 187 (Alta. C.A.).

41 *Nova Metal Products Inc.* v. *Comiskey (Trustee of)* (1990), 1 C.B.R. (3d) 101, (sub nom. *Elan Corp.* v. *Comiskey*) 1 O.R. (3d) 289 (Ont. C.A.); *Air Canada, Re* (2004), 47 C.B.R. (4th) 189 (Ont. S.C.J. [Commercial List]). For a discussion, see Janis P. Sarra, *Creditor Rights and the Public Interest, Restructuring Insolvent Corporations* (Toronto: University of Toronto Press, 2003).

42 A restructuring by the debtor or a going concern sale by a creditor may provide economic efficiency.

The board is likely to face pressures from both investors and creditors, as there are no longer sufficient assets to satisfy the corporation's outstanding claims.

1. Conflicts and Contributions

The directors are frequently shareholders themselves, both because of the closely held nature of many Canadian firms and because good governance practice today generally encourages directors to be remunerated largely in equity ownership. This may create some conflicts of interest in how the directors approach their oversight of the restructuring negotiations. The board may also require a different type of oversight of their managers, as they are also in a conflict of interest position as they work through the process. This may necessitate more aggressive oversight, creating new tensions between inside and outside directors.

At the same time, a diverse board with healthy connections to the sector in which the debtor company operates, may have considerable advice to offer in the workout period. The board has the continuity to appreciate what has worked and what has not worked in the past. The diversity of views may offer insights into possible new injections of equity into the company or the structuring of debt financing, or ideas about restructuring the operational side of the business. Independent directors can be particularly helpful to a chief restructuring officer who takes over management of the corporation. The courts generally do not interfere with the corporate board of an insolvent corporation under *CCAA* proceedings.

In *Stelco Inc.*, the Ontario Court of Appeal held that 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. 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. 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. The Court of Appeal held that what the court does under section 11 of the *CCAA* is establish the boundaries of the playing field and act as a referee in the process. The Court held that 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. In the course of acting as referee, the court has authority 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 that will be to the benefit of both the company and its creditors. The Court in *Stelco Inc.* observed that the fact that section 11 did not itself provide the authority for a *CCAA* judge to order the removal of directors, however, did not mean that the supervising judge was powerless to make such an order. The Court held that section 20 of the *CCAA* offers a gateway to the oppression remedy and other provisions of the *Canada Business Corporations Act (CBCA)* and similar provincial statutes.[4]

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[4] *Canada Business Corporations Act*, R.S.C. 1985, c. C-44.

Chapter 47, when proclaimed in force, will amend the *CCAA* to grant the court power to remove directors, specifying that the court may, on application of any person interested in the matter, make an order removing from office any director if the court is satisfied that the director is unreasonably impairing or is likely to unreasonably impair the possibility of a viable plan or is acting or likely to act inappropriately as a director in the circumstances.[5]

2. Fiduciary Obligations during Insolvency

The scope of directors' duties when the firm is financially distressed was recently decided by the Supreme Court of Canada in *Peoples Department Stores*.[6] Prior to the Supreme Court of Canada judgment in *Peoples Department Stores*, discussed below, Canadian courts had begun to recognize a shift in fiduciary obligation at the point of insolvency, finding that the directors' duty to a corporation as a whole extends to not prejudicing the interests of creditors in an insolvency context.[7] The Supreme Court of Canada in *Peoples Department Stores* ruled that the duty of directors and officers under the *CBCA* does not change when the corporation is approaching or is in financial distress, and that directors and officers owe their fiduciary duties solely to the corporation at all times.[8] It held that directors owe a duty of care to creditors, but that duty does not rise to a fiduciary obligation. However, in acting in the best interests of the corporation, the Court held that it may be legitimate for directors to consider the interests of shareholders, employees, suppliers, creditors, consumers, and the environment.

Courts in the U.K., Australia and the United States have long recognized that directors must consider the interests of creditors when the corporation is insolvent, although there are differences in opinion as to when that obligation arises.[9]

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5 Section 11.5(1), Chapter 47 (proposed amendment to the *CCAA*).

6 *Peoples Department Stores Ltd. (1992) Inc., Re* (2003), [2003] Q.J. No. 505, 2003 CarswellQue 145 (Que. C.A.), leave to appeal allowed (2003), [2003] S.C.C.A. No. 133, 2003 CarswellQue 3487, 2003 Carswell Que 3488 (S.C.C.), affirmed (2004), [2004] S.C.J. No. 64, 2004 CarswellQue 2862, 2004 Carswell Que 2863 (S.C.C.).

7 *Peoples Department Stores Ltd. (1992) Inc., Re* (1998), 1998 CarswellQue 3442, [1998] Q.J. No. 3571 (Qué. S.C.) (Bankruptcy and Insolvency Division) (Greenberg J.), reversed (2003), 2003 CarswellQue 145 (Que. C.A.), leave to appeal allowed (2003), 2003 CarswellQue 3487 (S.C.C.), affirmed (2004), 2004 CarswellQue 2862 (S.C.C.). *Canbook Distribution Corp. v. Borins* (1999), 45 O.R. (3d) 565 (Ont. S.C.J.) at para. 16; *Sidaplex-Plastic Suppliers Inc. v. Elta Group* (1998), 40 O.R. (3d) 563 (Ont. C.A.). See also J. Ziegel "Creditors as Corporate Stakeholders: The Quiet Revolution-an Anglo-Canadian Perspective" (1993) 43 U. T. L. J. 511.

8 *Ibid.*

9 See for example: *Winkworth v. Edward Baron Development Co.*, [1987] 1 All E.R. 114 (U.K. H.L.); *Walker v. Wimborne* (1976), 50 A.L.J.R. 446 (Australia H.C.). See also Andrew Keay, "The Director's Duty to Take into Account the Interests of Company Creditors: When is it Triggered?" (2001) 25 Melbourne University Law Review 315; Janis Sarra, "Taking the Corporate Ship Past the Plimsoll Line, Director and Officer Liability when the Corporation Founders" (2001) 10 International Insolvency Review 229.

In *Canadian Airlines*, the clause of the *CCAA* plan that compromised claims against directors did not make clear that the compromise was only relating to claims that arose prior to commencement of the proceedings and failed to make clear that the compromise excluded claims excepted by section 5.1(3) of the *CCAA*. The Court, during the sanctioning process, amended the plan to add words that clarified both of these statutory requirements.[118] The plan in that case also released claims against third parties such as officers and employees, and the Court held that although the *CCAA* does not expressly authorize a release of such claims, it does not prohibit such releases; hence it approved the release of claims.

While section 5.1 of the *CCAA* is helpful, it is often not a central focus for directors, as they have much less control over the outcome of the process than creditors. Jean-Daniel Breton has questioned the usefulness of the provisions of the *CCAA* purportedly protecting directors, as the liabilities that are most often a cause of concern for directors are obligations towards employees or towards governments; and the conditions giving rise to liability under the statutes creating these directors' personal obligations are not present in the context of a restructuring under the *CCAA*. He suggests that typically, under employment standards legislation, tax laws or supplementary pension plan legislation, the conditions giving rise to liability on a joint and several basis with the corporation include that the corporation has been sued for the debt and the judgment was incapable of being satisfied, or the company has been the object of liquidation proceedings or has become bankrupt, and the claim filed could not be satisfied.[119]

IV. CORPORATE MANAGERS – INFORMATIONAL CAPITAL OR ENTRENCHMENT?

The role of pre-filing corporate managers in a *CCAA* restructuring depends in large measure on the reasons for the financial distress, the relationship of the managers with the board, whether there is a need for a chief restructuring officer, and sometimes, the views of the most senior lenders.

The CEO and other officers may be integrally involved in the workout, bringing important informational capital to the development of a plan of arrangement or compromise. They can contribute industry or sector expertise; have a firm-specific understanding of supplier arrangements, operations and collective agreements; and

[118] *Canadian Airlines Corp., Re* (2000), 20 C.B.R. (4th) 1 (Alta. Q.B.), leave to appeal refused (2000), 2000 CarswellAlta 919 (Alta. C.A. [In Chambers]), affirmed (2000), 2000 CarswellAlta 1556 (Alta. C.A.), leave to appeal refused (2001), 2001 CarswellAlta 888 (S.C.C.).

[119] See the text by Jean-Daniel Breton, "Reorganizations: Objectives Contemplated and Achieved by Legislative Changes since 1992", in J. Sarra, ed., *Annual Review of Insolvency Law, 2003* (Toronto: Carswell, 2004). Breton suggests that the specific condition that the corporation has commenced restructuring proceedings under the *BIA* or *CCAA* is not customarily mentioned as one of the triggering conditions. For example, see section 131(2) of the Ontario *Business Corporations' Act*, R.S.O. 1990, chapter B.16, section 323(2) of the *Excise Tax Act*, R.S.C 1985, c. E-15 as amended, and section 53 of the Québec *Supplemental Pension Plans Act*, R.S.Q., chapter R-15.1.

may have a healthy relationship with pre-filing operating lenders. They are frequently also members of the board of directors and stay in that capacity as well.

Equally, however, it may be that the senior officers have significantly contributed to the firm's financial distress and senior creditors, in particular, want some assurance that the assets will not be further unnecessarily depleted during the stay period. In such cases, the debtor corporation (its directors and/or officers) may agree to a chief restructuring officer (CRO) or other turnaround expert to take over operations and negotiations for a plan. Alternatively, the parties may agree that the officers stay in place for a period, but that the monitor will take a more active role in oversight of decisions. A further alternative is that the parties may seek to have an interim receiver appointed within the context of the *CCAA* proceeding. In such cases, whether or not officers remain will depend on those who retain or acquire decision making power during the period of the *CCAA* proceedings. There is always some degree of management change. Often industry experts are hired, rather than a chief restructuring officer.

The board of directors of the debtor corporation often wants managers to remain because of the contributions they can make or because they have longstanding relationships as directors. In cases where it is important to retain senior officers to facilitate the workout, the courts have approved key employee retention plans (KERPs). KERPs can offer managers significant compensation to remain at the company, a golden parachute that guarantees their financial security on exit, and other incentives that encourage these officers to remain with the debtor corporation pending completion of the workout, and sometimes afterwards. KERPs can prevent the untimely loss of skills at a time when the debtor company is trying to continue to operate.[120]

However, there are also a number of instances in which officers use their strategic position to appropriate benefits for themselves. One example, discussed in chapter 4, is where managers are negotiating the size of the DIP facility at the same time they are bargaining for their own KERP or exit strategy. In such cases, there is a conflict of interest, as the officers may negotiate an excessive amount of DIP financing to ensure that the debtor corporation has the financial capacity to meet their compensation demands. Arguably, the *Air Canada* case was an example of this conflict. In other instances, officers bargain terms of DIP financing agreements that prohibit the board from replacing them without the approval of the DIP lender, a strategy that can firmly entrench the officers and can create the wrong incentive effects in terms of how those officers interact with the DIP lender and other stakeholders. While there are few cases to date in Canada, this is an area that may give rise to some litigation.

The Québec Superior Court recently considered the question of inherent jurisdiction in the context of a request to authorize a priority charge for an employee retention

[120] Recent amendments to the U.S. *Bankruptcy Code* have placed new limitations on the use of KERPs under Chapter 11 reorganization proceedings.

program.[121] In *MEI Computer Technology Group Inc.*, Mr. Justice Clément Gascon considered a request for a priming charge for an employee retention program in a *CCAA* proceeding for four groups of employees, including the project managers, key analysts, management and the chief restructuring officer.[122] The debtor sought a priority charge that ranked behind all existing secured debt but ahead of all subsequent security and all unsecured creditors. The Court drew an analogy with the tests used to determine whether or not to grant priming charges in a DIP facility, finding them helpful to its consideration of the issue before the court. The Court held that it would not exercise its inherent jurisdiction to allow the creation of a charge in favour of the employee retention program for the following reasons:

- The charge was aimed at guaranteeing the payment of base amounts to the employees covered, regardless of the outcome of the *CCAA* proceeding, even if the *CCAA* process ended up in liquidation; and thus it was difficult to justify the creation of the charge as the caselaw suggests priming orders should be made only when there exists a reasonable prospect of restructuring.

- The charge would essentially entail the financing of a salary increase for remaining employees by its unsecured creditors, including trade creditors and employees; and that it was difficult to see how this was just and equitable, particularly when, as creditors in the same class, they would likely be paid less than 100% of their claims and many employees had lost their employment.

- The balance that must exist between interest and prejudice among creditors of the same class was not present here.

- The burden of the charge was not shared equitably between the debtor's creditors; if the charge was really key to the debtor's ability to restructure, it was difficult to understand why the charge was created without apportioning some of the cost to secured creditors who would benefit directly from a successful restructuring.

- The cash flow projections were such that there appeared to be other practical ways to structure payments of the base amounts of the employee retention program and to reassure employees so that they stayed, such as tranches to employees over a shorter period.

- Finally, the court was not persuaded that such a charge was necessary to "keep the lights on", and therefore it was not a clear case warranting the creation of an additional charge.[123]

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[121] *MEI Computer Technology Group Inc., Re* (2005), 2005 CarswellQue 3675, [2005] Q.J. No. 5744 (Que. S.C.).

[122] *Ibid.*

[123] *Ibid.* at para. 26.

This reasoning helpfully used a set of underlying principles to determine whether the court should exercise its discretion in the circumstances to grant a priority charge.

The role of managers is often not visible to participants in the *CCAA* proceeding, because the "face" of the negotiator may not be the officer that is calling the shots. Yet corporate managers can be a pivotal force in either developing the workout plan or standing in the way of development of an effective plan.

V. THE ROLE OF THE CHIEF RESTRUCTURING OFFICER

In the past 15 years, there has been the growing use of chief restructuring officers (CROs) in *CCAA* workouts, frequently appointed in the initial stay order. This development is a governance response to creditor concerns that directors that may have skills appropriate to oversee financially healthy corporations may not have the skills or expertise to deal with a turnaround situation.

The CRO is vested with responsibility to steer the insolvent firm through the negotiation for a plan and the restructuring process. CROs tend to be "turnaround experts" that take over control of the corporation, replacing most of the functions of both the CEO and the directors. Algoma Steel, Loewen and Consumers Packaging Inc. are all recent examples of *CCAA* cases that utilized a CRO.[124] The appointment of a CRO can result in higher creditor confidence, particularly where creditors attribute the firm's financial distress to failures of governance. The CRO can also serve as a buffer between equity investors, directors, officers and creditors, undertaking the often tough negotiations required for an effective workout. As a new participant, the CRO has all the advantages of a fresh assessment of the financial distress and the potential for refinancing and a viable workout.

In *Ivaco*, the Court permitted the participation of a chief restructuring officer in the sale process of an insolvent company.[125] The CRO assessed the various bids and weighed each against the possibility of a stand alone restructuring, and ultimately made recommendations. The Court held that it would consider the following factors in examining the appropriate role of a CRO involved in the sale of an insolvent company: (1) that fairness to all creditors is a pre-requisite to a satisfactory sale process; (2) that a sale process should not result in one unsecured creditor receiving a secret benefit or advantage over other unsecured creditors; (3) that the sale process

[124] *Consumers Packaging Inc., Re* (2001) Toronto File No. 01-CL-4147 (Ont. S.C.); M. Forte, "The Recognition and Roles of the Chief Restructuring Officer in Canadian Insolvency Proceedings" (2001) 14 Comm. Insolvency Review 4.

[125] *Ivaco Inc., Re* (2004), 2004 CarswellOnt 2397, 3 C.B.R. (5th) 33 (Ont. S.C.J. [Commercial List]). For a general discussion, see Edward Sellers *et al.*, "Governance of the Financially Distressed Corporation: Selected Aspects of the Financing and Governance of Canadian Enterprises in Cross-Border Workouts" and Geoffrey Morawetz, "Under Pressure: Governance of the Financially Distressed Corporation", in Janis Sarra, *Corporate Governance in Global Capital Markets* (UBC Press, 2003).

must be seen to be fair and transparent; and (4) that the sale process ought to be determined by the court after considering the advice of the monitor, the position of the insolvent company and the positions of the creditors.[126]

A CRO was successfully utilized in the *Consumers Packaging Inc.* (CPI) proceeding, a company that supplied most of the domestic glass bottle market in Canada. It was publicly listed on the Toronto Stock Exchange, but 63.6% held by a shareholder who was also CEO and Chair of the board. CPI faced problems that included a pension deficit liability, aging capital assets, long-term fixed price contracts and enormous increases in input costs. When the corporation began to experience financial distress in 2001, the corporate board struck an Independent Restructuring Committee, recognizing the need for an independent assessment of the financial distress while preventing a control change and acceleration of financial obligations that would have been triggered by debt defaults or dilution of majority shareholder interest.[127] The committee hired a CRO who assumed operational control of the corporation, facilitated a complex debt arrangement and going concern sale process of CPI's principal operating assets under the supervision of the *CCAA* judge.

The workout in *Consumers Packaging Inc.* ultimately generated a value of $61 million greater than CPI's estimated liquidation value. The purchaser assumed the pension plan deficit of $35-45 million and other employee obligations.[128] Edward Sellers observes that the workout was facilitated by early recognition that an independent committee of directors and an independent CRO were needed to effectively assess and implement the corporation's options for a viable plan. The restructuring was accomplished by the going concern sale, driven by factors that included value maximization for almost all interested parties, preservation of supply relationships for ordinary trade creditors, preservation of more than 2,400 direct jobs, successor protection of the pension plan, and prevention of major disruption to the glass container and beverage market in Canada.[129]

1. Issues of CRO Accountability

Given that the CRO is a court-appointed officer, the supervision of the court can ensure a measure of accountability that is normally a function of the relationship between the corporate board and senior managers. If the CRO is court-appointed, arguably it has obligations to the court and must act neutrally with respect to stakeholders. If CROs have taken over the oversight or management of the affairs of the debtor corporation, arguably they also acquire a statutory duty of care to creditors and are required to consider the interests of all stakeholders with an interest

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[126] *Ivaco, ibid.*

[127] Edward Sellers *et al.*, "Governance of the Financially Distressed Corporation: Selected Aspects of the Financing and Governance of Canadian Enterprises in Cross-Border Workouts", in Janis Sarra, *Corporate Governance in Global Capital Markets* (UBC Press, 2003) at 38.

[128] *Ibid.* at 44.

[129] *Ibid.* at 45.