Andrew J.F. Kent
Tushara Weerasooriya
McMillan LLP

Introduction

Insolvency law in Canada is governed by two main federal statutes, the *Bankruptcy and Insolvency Act* (the "*BIA*") and the *Companies' Creditors Arrangement Act* (the "*CCAA*"). The latter functions for mid-size and larger cases as Canada's primary equivalent of Chapter 11 of the *United States Bankruptcy Code*, while the former contains both an equivalent to Chapter 7 and an abbreviated, simplified restructuring scheme used primarily in smaller cases. Unlike the United States, the Canadian federal government's interest in bankruptcy law reform has until recently been limited. Consequently, the *BIA* and *CCAA* (enacted in the depression-era) are old-fashioned statutes that did not address a variety of the issues arising in the modern restructuring environment.

This lack of statutory guidance led trial judges, over time, to take a more and more activist approach to the administration of restructuring cases through the use of judicial discretion, and an increasingly broad interpretation of the court's jurisdiction. The incremental development of restructuring law and practice in Canada, in time, led to the adoption of forms of relief familiar to US insolvency professionals, such as DIP financing, the retention or disclaimer of executory contracts and sales of businesses during a restructuring proceeding. However, the absence of clear statutory authority for this relief or any rules governing the granting of relief resulted in a lack of predictability in restructuring practice.

Law Reform Efforts

In an effort to introduce a more black-letter law approach to insolvency law in Canada, the Canadian parliament passed the "Act to establish the Wage Earner Protection Act, to amend the *Bankruptcy and Insolvency Act* and *Companies' Creditors Arrangement Act* and to make consequential amendments to other acts" (the "*Reform Act*")[1] in November, 2005. After a long and sometimes uncertain political and industry review process, the *Reform Act* was finally proclaimed into force on September 18, 2009.

As its name suggests, the *Reform Act* addresses certain perceived injustices to workers under current restructuring law. However, the bulk of the *Reform Act* amendments involve an effort to bring more consistency to the restructuring practice across the provincial jurisdictions in Canada.

In a number of respects, the *Reform Act* codifies practices that were developed from US principles and therefore brings the Canadian restructuring system somewhat closer to the US system. That being said, some aspects of the amendments may ultimately widen the gulf between the two systems. The following are some highlights of the amendments made by the *Reform Act*.

DIP Financing

The court now has the express power to authorize debtor-in-possession ("DIP") financing and to grant super-priority liens to secure DIP facilities. In deciding whether to exercise this power, the court is mandated to consider the following factors: the expected length of the proceeding, the governance of the debtor, the degree of creditor confidence in management, the degree to which the DIP will enhance the debtor's business prospects, the nature and value of the property secured, prejudice to creditors and the recommendation of the trustee or monitor. These guidelines are largely a codification of rules developed in the case law over the last 15 years.

One notable change introduced by the *Reform Act* is the express prohibition on granting DIP liens that secure pre-filing obligations. As a consequence, it puts into question whether "roll-up" DIPs, which are designed to refinance existing senior debt on a super-priority basis, will be permitted going forward. Prior to the amendments, "roll-up" DIPs had become increasingly popular in Canada, particularly in the context of US-Canada cross-border insolvency proceedings.

Other Court-Ordered Liens

The *Reform Act* also provides the court with express authority to grant various additional priming liens to secure:

- payment of fees and costs (including legal costs) incurred by trustees, receivers or *CCAA* monitors, as well as any financial, legal or other experts engaged by the debtor and potentially by other "interested parties";
- if adequate insurance is not available at a reasonable cost, the payment of post-filing obligations incurred by directors and officers in such capacity; and
- critical vendor payments, relief that until now had been granted sparingly in Canada.

The ultimate effect of codifying the express authority to grant DIP liens and other priming liens may be to make it more difficult for existing secured creditors to oppose DIP financing and to contain the administrative costs of an insolvency proceeding.

Asset Sales

Prior to the amendments, there were lingering doubts as to the validity of asset sales out of the ordinary course during a restructuring, particularly in the case of going-concern sales of a business. Debtors are now expressly authorized to sell or otherwise dispose of assets outside of the ordinary course of business with court authorization. Although not as comprehensive as section 363 of the *US Bankruptcy Code*, the *Reform Act* does introduce a number of factors to be considered by the court when deciding how to exercise its discretion, including: the reasonableness of the sale process, the recommendation of the trustee or monitor, whether a sale in the restructuring provides a better result to creditors than a liquidation, the degree of creditor input into the sale process, prejudice to creditors and other stakeholders and the application of a "fair and reasonable" test to the purchase price. More stringent factors will apply where the proposed sale is to a related person.

Executory Contracts

The treatment of executory contracts and, in particular, the power of the court to authorize the debtor to assign such contracts without counterparty consent, had been the subject of material legal debate in Canada. The *Reform Act* introduces a new regime for the dealing with executory contracts which codifies the debtor's right to disclaim or assign (without consent) executory contracts with court authorization. The new regime is relatively simple as compared to the provisions of the *US Bankruptcy Code*, relying heavily on the exercise of judicial discretion within mandated guidelines.

One area in which Canadian insolvency law will now differ from US law is in the treatment of collective bargaining agreements. The *Reform Act* provides greater protection for union contracts. Specifically, the reforms oust any jurisdiction of the bankruptcy court to terminate union contracts, and require ongoing compliance with union contracts during a restructuring proceeding. Union contracts can only be modified during a restructuring process through normal collective bargaining, although in certain situations the court has authority to trigger an obligation to bargain in good faith. As a result, it is anticipated that going forward, the odds of unionized businesses being liquidated rather than being reorganized or sold as going concerns will be greater. That being said restructurings involving unionized businesses remain a possibility where the union proves to be quickly responsive at the outset of the case.

Governance Issues

The success of a restructuring is often dependent on the competence and commitment of the directors and officers of the debtor. The availability of indemnities for certain post-filing directors and officers liabilities, on a super-priority basis (as discussed above) provide incentives for directors and management to stay on during a restructuring. There are, however, instances where inexperience or personal agendas may hinder the restructuring process. The *Reform Act* now authorizes the court to remove or replace a director that may unreasonably impair the ability of a debtor to achieve a viable plan or proposal or who is unlikely to act in the debtor's best interests. Whether courts will exercise this power outside of exceptional circumstances is open to debate. Still, the mere existence of this remedy may place greater discipline on debtors and protect stakeholders from governance failures.

In addition, the *Reform Act* introduces enhanced protections for receivers against liability as successor employers. Recent case law had heightened concerns about receivers becoming personally liable for employment related obligations such as wages, vacation pay, severance and termination pay and pension claims. These concerns had lead to an unofficial freeze on going-concern receiverships. The amendments now resolve these concerns and, as a result, receiverships are once again available as an alternative solution to governance issues.

Employees

In 2008, part of the employee protection portions of the *Reform Act* were brought into force. Specifically, employees received the benefit of government wage insurance, which was backstopped by a super-priority working capital lien. In addition, employees received the benefit of a new super-priority lien against all assets of the debtor for current service pension contribution arrears. The 2008 amendments dealt only with the liquidation scenarios. Now that the remainder of the *Reform Act* has been brought into force, the approval of restructuring plans are now expressly conditional on treatment of employees that mirrors the wage and pension protections provided to employees in liquidations.

Unsecured Creditors and Critical Suppliers

A number of the amendments introduced by the *Reform Act* enhance the protections provided to unsecured creditors and suppliers. In particular, the power of the court to grant priming liens to other "interested parties" may provide greater opportunities for creditors to form committees funded by the debtor. Until now, creditors committees were usually formed on an *ad hoc* basis with the consent of the debtor and appeared only in larger cases. The amendments make it more likely that the courts will consider authorizing the funding of creditors committees without the consent of the debtor.

The court now has the express authority to compel critical suppliers to supply, potentially without a subsisting ongoing supply contract. When such an order is made, critical suppliers are entitled to lien protection for such post-filing supply. In addition, trade creditors have been granted enhanced protections for the price of goods supplied 30-days before a liquidation proceeding is commenced against the debtor.

The *Reform Act* also introduces fraudulent preference and conveyance type litigation into the CCAA. The *Reform Act* expressly imports the enhanced fraudulent preference provisions of the *BIA* into the restructuring statutes and introduces the new concept of "transfers at undervalue", which largely replaces the more arcane fraudulent conveyance provisions in the *BIA*. These new avoidance provisions are likely to play a more prominent role in future restructurings and may give rise to more US style litigation and litigations trusts for the benefit of unsecured creditors.

Finally, in an effort to promote consistency in the restructuring practice, the *Reform Act* provides small business debtors (under C$5 million in debt) with access to the big case toolkit *e.g.* DIPs, asset sale and executory contract provisions.

Conclusion

The content of the *Reform Act*, in many ways, reflects a policy to move away from *ad hoc* restructuring practices, towards a more structured and principle based approach to insolvency law. As noted above, many of the "reforms" are codifications with modifications of practices developed by some bankruptcy courts over the last 15 years. In other words, the amendments are more evolutionary than revolutionary. That being said, the *Reform Act* introduces numerous technical amendments which will undoubtedly give rise to disputes, litigation and, potentially, surprises. In the final analysis, as was the case with the 2005 amendments to the *US Bankruptcy Code*, the *Reform Act* may ultimately prove to have a lasting and material impact on insolvency law and practice in Canada. ■

1. The *Reform Act* is referenced as chapter 47 of the Statutes of Canada, 2005.

Andrew J.F. Kent, *McMillan LLP*
Tel: (416) 865-7160 • Fax: (647) 722-6715 • E-mail: andrew.kent@mcmillan.ca

Andy is Chair of the firm's Debt Products and Restructuring Group. He practices business law with a focus on corporate restructuring, lending, and private mergers & acquisitions. He is recognized nationally and internationally both as a leading Canadian banking practitioner and as one of Canada's pre-eminent restructuring practitioners. Representative transactions include major reorganizations and financings in the airline, telecommunications, electrical utility, media, manufacturing, agricultural, real estate, retail, financial services and automotive sectors. He was an architect of many innovative restructuring transactions. Andy is very experienced in cross-border financings and insolvencies and international matters, and has played a key role in insolvency law developments in Canada. He has led professional efforts to reform Canada's business insolvency laws and has lectured extensively on reorganisations, directors' duties, secured and unsecured lending and guarantees. Andy was an Adjunct Professor of the Faculty of Law, University of Toronto. Memberships include the CBA, IIC and ABI.

Tushara Weerasooriya, *McMillan LLP*
Tel: (416) 865-7262 • Fax: (416) 865-7048 • E-mail: tushara.weerasooriya@mcmillan.ca

Tushara is an associate in McMillan's Corporate Restructuring Group. She joined McMillan in 2003 as a summer student and completed her articles with the firm in 2005. Tushara's practice involves all aspects of insolvency law including reorganizations, bankruptcies, receiverships, security enforcements and cross-border insolvencies. Tushara has advised banks, financial institutions and borrowers in domestic and cross-border restructuring proceedings. Tushara regularly advises court-appointed receivers and monitors and trustees in bankruptcy. In addition, Tushara has experience with automotive insolvencies and has advised banks, OEMs and part suppliers in connection with several automotive restructurings.