COMMENTARY: Can debtors foil rights of valid claims purchasers?

By Max Mendelsohn and Marc-André Morin

The Lawyers Weekly

Vol. 27, No. 16
(August 31, 2007)

FOCUS ON BANKRUPTCY & INSOLVENCY

A recent judgment of the Quebec Superior Court, rendered in the context of a Companies' Creditors Arrangement Act (CCAA) reorganization, has raised issues which may complicate the purchase of claims against an insolvent or reorganizing debtor.

In Minco-Division Construction Inc. v. 9170-6929 Québec Inc., [2007] Q.J. No. 449, Minco and Sleb, operating under a CCAA stay of proceedings, arranged for a new entity to purchase the secured claim of its first-ranking secured creditor, amounting to approximately $20,000,000 for the discounted sum of approximately $13,000,000. The reorganizing entities and the purchaser had some common minority shareholders.

After the purchase, a falling-out occurred between the purchaser and the debtors, after which a dispute occurred over whether or not the purchaser could participate in the CCAA proceedings for the full amount of the purchased claim. The debtors, whose position was supported by the common minority shareholders, claimed that the purchaser's entitlement was limited to the discounted amount paid for the claim.

After a lengthy hearing, with contradictory evidence, the court concluded that the purchaser had been created solely for the purpose of acquiring secured claims against the debtors at the lowest possible cost and assisting the debtors in their restructuring. It concluded, as a factual matter, that the parties had agreed that the purchaser, acting as what the court characterized as a "white knight" , had agreed to limit its claims to their purchase price. The court limited the claims accordingly.

The court's findings would likely have been of no significant interest to anyone other than the parties involved, were it not for a somewhat gratuitous assertion (italicized) in the following statement:

"These claims were "settled" or compromised following negotiations between arms' length parties for amounts that reflect their respective values at the time they were assigned. These assignments were all made during a litigious period for litigious purposes. Had there been no agreement to treat the claims as 'litigious rights', the Court concludes that in the context of CCAA proceedings they had become litigious claims, at the very least to the extent they had been compromised by arms' length negotiations...The Bank was under no compulsion to accept one penny less than what it esti-

mated it might receive from foreclosure under its hypothecary loan. It is in this sense that the claim had become 'uncertain' prior to its acquisition."

The Civil Code of Quebec has a provision, based on a policy of avoiding traffic in litigious claims (Champerty), under which a debtor of a purchased litigious claim can obtain a discharge of the claim by paying the purchaser the amount paid by the purchaser for the claim. A claim is defined as being litigious when it is uncertain, contested or contestable by the debtor.

In Minco, there was no suggestion that the claim owed by the debtors to the vendor was in any way disputed or subject to a potential dispute.

The question of whether a claim is litigious is a matter which relates to the circumstances and quality of the claim. It has nothing whatsoever to do with the question of whether the claim is collectable or not as a result of the financial circumstances of the debtor.

Moreover, even in circumstances where a claim is litigious, and the debtor is entitled to obtain a discharge by paying the amount paid, the amount must be paid. There is no concept whereby the claim is reduced in the absence of a payment.

In a case where it matters, it is unlikely that a court would accept the proposition that a purchased claim is litigious solely as a result of the fact that the debtor is insolvent; nor should it order a reduction of a claim which is actually litigious in the absence of the tender of the amount paid by the purchaser.

Unfortunately, however inadvertently, the door has been opened for a future debtor to attempt to frustrate the rights of a bona fide purchaser of an undisputed claim. Hopefully, such an attempt would be thwarted quickly.

Meanwhile, the obiter dictum in Minco may create an unfortunate complication in the quite legitimate, and commercially beneficial, practice of claims trading.

Max Mendelsohn and Marc-André Morin are Montreal-based members of the Corporate Restructuring Group of McMillan Binch Mendelsohn. The firm represented a secured creditor in the CCAA proceedings who was not a party to, and did not participate in, the dispute which led to the judgment in Minco.