Bankruptcy and Restructuring

BANKRUPTCY AND RESTRUCTURING

Under Canadian constitutional law, the federal government has exclusive legislative control over bankruptcy and insolvency matters. Insolvency proceedings in Canada may take a variety of different forms. When a corporation becomes insolvent, two options are generally available: (i) liquidate the corporation’s assets for the benefit of its creditors, or (ii) restructure the affairs of the corporation. Although several different legislative regimes are available to effect either a liquidation or a restructuring of a corporation, the Bankruptcy and Insolvency Act (BIA) and the Companies’ Creditors Arrangement Act (CCAA) are the two most common federal statutes employed for these purposes. The BIA provides for both restructurings (via BIA proposals) and liquidations (via bankruptcies) of insolvent businesses, while the CCAA is used primarily for the restructuring of more complex corporate businesses, although it can also be used to conduct a sale or liquidation.

Bankruptcy and Insolvency Act (BIA)

Bankruptcy

The term “bankruptcy” refers to a formal procedure under the BIA to effect the liquidation of a debtor’s assets by a trustee in bankruptcy. A bankruptcy can either be voluntary or involuntary and can be brought in respect of any insolvent person that has an office, assets or carries on business in Canada, with the exception of banks, insurance companies, trust or loan companies, and railway companies (for which other insolvency legislation exists).

A voluntary bankruptcy under the BIA commences when a debtor files an assignment in bankruptcy with the Office of the Superintendent of Bankruptcy.

An involuntary bankruptcy under the BIA commences when a creditor with a debt claim of at least $1,000 files an application for a bankruptcy
order with the court. This proceeding is brought on behalf of all creditors, although it is not necessary for more than one creditor to join in the application. In order to obtain the bankruptcy order, the creditor must establish that the debtor has committed an act of bankruptcy within six months preceding the commencement of the bankruptcy proceedings. The most common act of bankruptcy is failing to meet liabilities generally as they become due. In addition to being placed into bankruptcy pursuant to a court order made upon application by a creditor, a debtor can also be placed into bankruptcy under the BIA if its proposal (discussed below) is rejected by its unsecured creditors or is not approved by the court.

The practical effect of a bankruptcy is the same whether it is commenced voluntarily or involuntarily: the debtor’s assets vest in its trustee in bankruptcy, subject to the rights of the debtor’s secured creditors. The trustee in bankruptcy is a licensed insolvency professional or firm that is appointed by the bankrupt or the bankrupt’s creditors.

There is an automatic stay of proceedings by unsecured creditors of the debtor upon the commencement of the debtor’s bankruptcy proceedings. However, the stay does not affect secured creditors, who are generally free to enforce their security outside the bankruptcy process unless the court otherwise orders (which is exceedingly rare).

The bankruptcy trustee has many duties. The most important is to liquidate the assets of the debtor for the benefit of its creditors. In addition, the trustee in bankruptcy is responsible for the administration of claims made against the bankrupt estate in accordance with the relevant provisions of the BIA. If appropriate, the bankruptcy trustee may also investigate the affairs of the debtor, to determine whether any fraudulent conveyances, preferences or transfers at undervalue were effected by the debtor, prior to the bankruptcy.
The creditors will generally meet shortly after the debtor becomes bankrupt, and appoint a group of up to five individuals known as “inspectors” to work with and supervise the trustee in bankruptcy. With the approval of the inspectors, the trustee in bankruptcy may sell the assets of the bankrupt estate.

A corporation may not be discharged from bankruptcy unless all of the provable claims against it have been satisfied, which may occur by payment in full or pursuant to a successful BIA proposal.

**BIA Proposals**

Generally speaking, the restructuring provisions under the BIA are most commonly used for smaller, less complicated restructurings. This means small and medium-sized corporations tend to use the BIA process, as opposed to the CCAA process. A restructuring under the BIA is commenced by a debtor either filing a proposal (i.e., its restructuring plan) or filing a notice of intention to file a proposal (NOI).

Upon the filing of an NOI or the filing of the proposal itself, the BIA imposes a stay of proceedings against the exercise of remedies by creditors against the debtor’s property or the continuation of legal proceedings to recover claims provable in bankruptcy. Provisions in security agreements providing that the debtor ceases to have rights to use or deal with the collateral upon either insolvency or the filing of a notice of intention to make a proposal under the BIA have no force or effect. The BIA also provides that, upon the filing of an NOI or the filing of a proposal, no person may terminate or amend any agreement with the insolvent person or claim an accelerated payment under any agreement with the insolvent person simply because the person is insolvent or has filed an NOI or a proposal. The court can lift a stay in a BIA restructuring if the creditor is able to demonstrate that it will be “materially prejudiced” by the stay or if it is equitable on other grounds that the stay be lifted.

It is more common for a debtor to start the process by filing an NOI, rather than by filing a proposal immediately. If the debtor files an NOI,
a copy of the written consent of a licensed trustee in bankruptcy, consenting to act as the proposal trustee in the proposal proceedings, must be attached to the NOI. Where an NOI is filed, the debtor must file cash flow statements for its business within 10 days and must file its proposal within 30 days. The court can extend the time for filing a proposal for up to a maximum of five additional months, although the court can only grant extensions for up to 45 days at a time.

During the process, the debtor normally carries on its business as usual, subject to monitoring by its proposal trustee and the supervision of the court. Ultimately, the debtor may table a proposal to its creditors. The BIA requires a proposal to contain certain terms, including: (i) the payment of preferred claims (such as certain types of employee claims) in priority to claims of ordinary creditors; (ii) the payment of all proper fees and expenses of the proposal trustee and incidental to the proceedings; (iii) the payment of tax remittances, such as employee source deductions, within six months of the approval of the proposal; and (iv) the payment to the proposal trustee of all consideration to be paid out under the proposal, for distribution to creditors.

A proposal must be made to the unsecured creditors generally, either providing for all unsecured creditors to be placed into one class or providing for separate classes of unsecured creditors. A proposal may also be made to secured creditors in respect of any class or classes of secured claims.

A proposal is deemed to be accepted by the creditors if all classes of unsecured creditors vote for the acceptance of the proposal by a majority in number and two-thirds in value of the unsecured creditors of each class. In practice, there is usually only one class of creditors to which a proposal is directed — the unsecured creditors. Secured creditors are usually dealt with by individual negotiation under the BIA, since a commonality of interest within each secured creditor class is required and there are seldom multiple secured creditors that can be
grouped together as a class on this basis. If the proposal is approved by the creditors, it must then be approved by the court. When deciding whether to approve the proposal, the court must be satisfied that, among other things, it is reasonable, calculated for the benefit of creditors and meets the technical requirements of the BIA.

If a BIA proposal is not approved by the requisite “double majority” of unsecured creditors, the debtor is automatically placed into bankruptcy. A BIA proposal will also fail if the court refuses to approve it. Finally, if after receiving court approval of the proposal the debtor defaults in its performance of the proposal, the court may annul the proposal, which then leads to an automatic assignment of the debtor into bankruptcy.

**Companies’ Creditors Arrangement Act (CCAA)**

Generally speaking, the restructuring provisions under the CCAA are most commonly used for larger, more complicated restructurings. This means larger sized corporations tend to use CCAA proceedings to restructure.

To qualify to use the CCAA, a “company” (as defined in the CCAA) must be insolvent and must have outstanding liabilities of $5 million or more. To initiate the proceedings, the company brings an initial application to court for an order (referred to as the Initial Order), imposing a stay of proceedings on creditors (i.e., a freeze on the payment of indebtedness) and authorizing the company to prepare a plan of arrangement to compromise its indebtedness with some or all of its creditors.

The materials presented to the court include a proposed form of Initial Order and an affidavit prepared by the company describing its background, its financial difficulties and the reasons why it is seeking the protection of a court order made under the CCAA. After reviewing the materials and hearing submissions from counsel, the judge exercises his or her discretion as to whether to make an Initial Order and on what terms. Usually, the Initial Order is made in the form of the order requested by the company, with little or no input from creditors and other stakeholders. However, certain relief
can only be granted on notice to secured creditors likely to be affected thereby (for example, interim financing) and in any event affected parties have the right to apply to court to vary the Initial Order after it is made.

Typically, an Initial Order does the following things:

a) authorizes the company to prepare a plan of arrangement to put to its creditors;

b) authorizes the company to stay in possession of its assets and to carry on business in a manner consistent with the preservation of its assets and business;

c) prohibits the company from making payments in respect of past debts (other than any specific exceptions allowed by the court, such as amounts owing to employees) and imposes a stay of proceedings: (i) preventing creditors and suppliers from taking action in respect of debts and payables owing as at the filing date; and (ii) prohibiting the termination of most types of contracts by counterparties;

d) appoints a monitor (a licensed bankruptcy trustee) as an officer of the court, to monitor the business and financial affairs of the company during the proceedings;

e) authorizes the company, if necessary, to obtain interim financing to ensure that it can fund its operations during the proceedings, including setting limits on the aggregate funding and the priority of the security (commonly known as “DIP financing”); and

f) authorizes the company to disclaim unfavourable contracts, leases and other agreements, subject to some limited exceptions.

The CCAA provides that an Initial Order may only impose a stay of proceedings for a period not exceeding 30 days. Once an Initial Order has been made, the company may apply for a further order or orders extending the stay of proceedings. The intention is to have the stay of proceedings continue until the company’s plan of arrangement has been presented to the creditors and approved by the court. As a general matter, the duration of proceedings
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under the CCAA usually ranges between 6 to 18 months from the commencement of proceedings to the sanctioning of a plan of arrangement. However, the proceedings can be much quicker if the terms of the plan of arrangement have already been worked out in advance of the filing. The court may terminate the proceedings under the CCAA, upon application of an interested party, if the court believes that it is unlikely that a consensual arrangement will be achieved or that the continuation of the proceedings is otherwise not appropriate. However, such orders are rare, at least at the initial stages of the restructuring.

In recent years, the CCAA has also been used as a means by which a sale of particular assets of the company, or the entire company, is conducted. The sale process runs on a parallel, alternate track to the restructuring process with a view to maximizing value for the stakeholders. In such circumstances, approval of the sale must be sought from the court on notice to the affected secured creditors, among others, in a process similar to a court receivership sale.

During CCAA proceedings, the debtor company typically continues to carry on business as usual. Significant transactions out of the ordinary course of the debtor’s business are usually submitted to the court for approval. The role of the CCAA Monitor is generally limited to monitoring and reporting to creditors and to the court regarding the debtor’s business and operations. When a CCAA plan of arrangement is developed, it ordinarily will divide the creditors into classes and will provide for the treatment of each class (which can be substantially different between classes). The classification of creditors must be approved by the court prior to any creditor meeting on the plan. In this regard, the guiding legal principle set out in the CCAA and applied by the courts in considering classification issues is whether there is a commonality of interest among the creditors in the class.

For a plan of arrangement to be approved by the affected creditors, a majority in number of the creditors representing two-thirds in value of the claims of each class (other than equity claims), present and voting
(either in person or by proxy) at the meeting or meetings of creditors, must vote in favour of the plan of arrangement. Parties related to the company cannot vote in favour of the plan. If the plan of arrangement is approved by the creditors, it must then be approved by the court. In doing so, the court must determine that the plan of arrangement is “fair and reasonable”. Upon approval by the creditors and court, the plan of arrangement is binding on all of the creditors of each class affected by the plan. If a class of creditors (other than a class consisting of equity claims) does not approve the plan, the plan is not binding on the creditors within that class.

The court cannot sanction a plan if it does not provide for the payment in full of certain Crown claims and certain employee and pension liabilities, or if it does not in effect subordinate “equity claims” to the claims of creditors. A plan may include releases in favour of non-debtor third parties in certain cases.

Additionally, if a debt restructuring involves a reorganization of the share capital of a company, it is possible to reorganize the share capital of the company by way of the CCAA court sanction order without a shareholder vote. In recent years, this device has been used, in effect, to extinguish the existing share capital and issue new shares to creditors in satisfaction of their claims or to a new equity investor (whose investment may fund distributions to the creditors).

If a CCAA plan is not approved by the requisite “double majority” of creditors, there is no automatic assignment of the debtor company into bankruptcy. Typically, what may lead to the bankruptcy of the debtor is the court’s refusal to extend or decision to otherwise terminate, the stay of proceedings by creditors against the debtor company, thereby allowing those creditors to exercise their lawful remedies against the debtor. If a sale of the assets occurs before the filing of a plan and meeting of creditors, consideration would be given to the benefits of proceeding toward a plan (presumably, to distribute the proceeds of the sale) as opposed to terminating the CCAA proceedings, for example, by commencing bankruptcy liquidation proceedings.