BANKRUPTCY AND RESTRUCTURING

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Introduction

Insolvency proceedings in Canada may take a variety of different forms. However, when a corporation becomes insolvent, two options are generally available: (i) restructure the business of the corporation, either through a compromise of its liabilities or through a going-concern sale, or (ii) liquidate the corporation's assets for the benefit of its creditors.

WHEN A CORPORATION BECOMES INSOLVENT, TWO OPTIONS ARE GENERALLY AVAILABLE: (I) SELL AS A GOING CONCERN OR LIQUIDATE THE CORPORATION'S ASSETS FOR THE BENEFIT OF ITS CREDITORS, OR (II) RESTRUCTURE THE BUSINESS OF THE CORPORATION.

Under Canadian constitutional law, the federal government has exclusive legislative control over bankruptcy and insolvency matters and different legislative regimes are available to effect either a restructuring or a liquidation 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 liquidation.

Bankruptcy and Insolvency Act (BIA)

Bankruptcy

The term "bankruptcy" refers to a formal procedure under the BIA which allows a licensed insolvency trustee to liquidate a debtor's assets, determine creditors' claims and distribute the proceeds of the liquidation to creditors. 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 and trust or loan companies, for which other federal insolvency legislation exists (the *Winding-up and Restructuring Act*).

Voluntary Bankruptcy

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

Involuntary Bankruptcy

An involuntary bankruptcy under the BIA commences when a creditor with a debt claim of at least C$1,000 files an application with the court for a bankruptcy order against the debtor. 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 for a creditor to obtain a bankruptcy order, the creditor must prove, on a balance of probabilities, that it is owed at least C$1,000 on an unsecured basis and the debtor has committed an "act of bankruptcy" within six months preceding the filing of the application. The most common act of bankruptcy is the debtor failing to meet its 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. A proposal may also fail and result in the debtor's bankruptcy if the debtor does not fulfil the terms of the proposal or otherwise fails to fulfil its obligations under the BIA.

Trustee in Bankruptcy and its Role

The practical effect of a bankruptcy is the same whether it is commenced voluntarily or involuntarily: the debtor's assets automatically vest in the trustee in bankruptcy, subject to the rights of secured creditors, trust claimants, and 30-day suppliers. A trustee in bankruptcy must be a Licensed Insolvency Trustee (LIT), which is an insolvency professional or firm that has been granted a licence by the OSB.

The trustee has many duties, the most important of which is to liquidate the debtor's assets for the benefit of its creditors. In addition, the trustee is responsible for the administration of claims asserted against the bankrupt estate in accordance with the relevant provisions of the BIA. If appropriate, the trustee may also investigate the affairs of the debtor to determine whether the debtor carried out any fraudulent conveyances, preferences, transfers at undervalue or improper dividends prior to the bankruptcy.

The creditors will generally meet shortly after the debtor becomes bankrupt and are entitled to appoint a group of up to five individuals known as "inspectors" to work with and supervise the trustee. With the approval of the inspectors, the trustee may sell the debtor's assets.

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.

Stay of Proceedings

There is an automatic stay of proceedings by unsecured creditors of the debtor upon the commencement of the debtor's bankruptcy proceedings, which prevents unsecured creditors from enforcing their rights against the debtor or its property. 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).

Restructuring: BIA Proposal and Going-Concern Sales

The restructuring provisions under the BIA (as compared to the CCAA) are most commonly used for smaller, less complicated businesses. This means small- and medium-sized corporations tend to use the BIA process rather than the CCAA process (discussed below), to seek to restructure their obligations to creditors or conduct a going-concern sale. A restructuring under the BIA is commenced by a debtor filing either a proposal (e.g., its restructuring plan) or a notice of intention to make 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. The specific stay language is set out in the BIA. 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 an NOI 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 may 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 to do so on other grounds.

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 an LIT, consenting to act as the proposal trustee in the proposal proceedings, must be attached to the NOI. If 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 (unless the time is extended). 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.

BIA Proposal

During the BIA proposal process, the debtor may present a proposal to its creditors. The BIA requires certain terms in the proposal for the court to approve it, 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 relating to the proceedings; (iii) the payment of certain 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 that provides for payment of equity claims cannot be approved by the court unless it provides that all claims that are not equity claims are to be paid in full.

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 "double majority" — a majority in number of the unsecured creditors, holding at least two-thirds in value of the claims in each class (other

than equity claims). Parties related to the debtor cannot vote in favour of the proposal. In practice, a proposal is typically only directed at the unsecured creditors. Secured creditors are usually dealt with by individual negotiation, since there must be a commonality of interest among creditors grouped together as a class and there are seldom multiple secured creditors that can be grouped on this basis. Therefore, there is often little practical benefit to addressing secured claims within the proposal.

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, the proposal 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 or not approved by the court, the debtor is automatically placed into bankruptcy.

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 bankruptcy of the debtor.

BIA Sale as a Going Concern

As an alternative to tabling a proposal and seeking the agreement of creditors to compromise their claims, the debtor may pursue a sale as a going concern. 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.

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

The CCAA is most commonly used to restructure larger, more complicated businesses. Therefore, the CCAA is often the preferred statute for larger-sized corporations seeking to restructure or to conduct a going-concern sale.

To be eligible to obtain relief under the CCAA, the debtor must be a company (as defined in the CCAA), have outstanding liabilities of C$5 million or more, and be insolvent, bankrupt, or have committed an act of bankruptcy under the BIA.

Initial Application

A CCAA proceeding is generally commenced by a debtor company bringing an initial application to the 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 on an initial application include: (i) a cash-flow forecast of the debtor; (ii) the debtor's recent financial statements; (iii) a proposed form of Initial Order; and (iv) 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 presiding judge will exercise his or her discretion to decide whether to grant an Initial Order and, if so, on what terms. There is significant judicial discretion, and therefore flexibility, as to the scope of the stay of proceedings and other terms in the Initial Order, since specific language for such terms are not prescribed in the CCAA. 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. In most jurisdictions, there is a form or order that has been adopted as a model upon which Initial Orders in that jurisdiction are based with a view to creating greater consistency in CCAA proceedings. 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 the court to vary the Initial Order after it is granted.

Typically, an Initial Order does the following:

— authorizes the company to prepare a plan of arrangement to present to its creditors;

— 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;

— 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 by secured and unsecured creditors: (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;

— appoints a monitor (who must be a Licensed Insolvency Trustee (LIT)) to monitor the business and financial affairs of the company during the proceedings. As an officer of the court, the monitor must take into account the interests of all stakeholders and report on the debtor's reorganization progress from time to time;

— 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

— 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 10 days. The court's jurisdiction to provide relief pursuant to an Initial Order during this period is also limited to that which is "reasonably necessary for continued operations of the debtor company in the ordinary course of business." 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 or a sale has been implemented. On an extension application, the applicant must satisfy the court that: (i) it has acted in good faith and with due diligence; and (ii) the circumstances remain appropriate for the continuation of the CCAA proceedings.

As a general matter, the duration of proceedings under the CCAA usually ranges between six to 18 months from the commencement of proceedings to the implementation 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 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 a restructuring.

On November 1, 2019, the CCAA was amended to include an express duty of good faith for any "interested person" in a CCAA proceeding. If the court finds that an interested person has failed to act in good faith, it has broad discretion to make any order it considers appropriate in the circumstances.

Plan of Arrangement

A plan of compromise and arrangement is the restructuring plan put forward by a company to its creditors. When a CCAA plan of arrangement is developed, it ordinarily will divide the creditors into classes and will provide for the treatment of the pre-filing claims 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.

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.

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 implementation of the plan following its approval by the creditors and court, the plan of arrangement is binding on all of the creditors of each class affected by the plan. Typically, the plan will provide for the release of the debtor company from the claims of affected creditors.

The court cannot approve 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 order approving the plan, 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 bankruptcy of the debtor company. Typically, what may lead to the bankruptcy of the debtor is the court's refusal to extend, or a decision to terminate, the stay of proceedings against the debtor company, thereby allowing creditors to exercise their lawful remedies against the debtor company. If a sale of the assets occurs without a CCAA being proposed, 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.

Asset Sales

During CCAA proceedings, the debtor company typically continues to carry on business as usual. A debtor is entitled to continue to sell assets in the ordinary course of business without an order of the court. However, significant transactions outside the ordinary course of the debtor's business typically require court approval.

The CCAA may be used to conduct the sale of particular assets of the company or the sale of its entire business as a going concern as an alternative to a restructuring by way of a plan of arrangement. 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.

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