RESCUE AND LIQUIDATION IN RESTRUCTURING LAW

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Two critical questions emerge when considering rescue and liquidation in Canadian restructuring law. The first is whether the use of the traditional restructuring to rescue a financially distressed firm has become a thing of the past — whether it is on its way out and being replaced with a court-supervised sale mechanism as the preferred method for ensuring that the value of the assets of an insolvent firm will be maximized. The second is about the appropriate method for effecting a liquidation in the event that this is considered to be the preferred route — does it make sense to be using a scheme that was originally designed for restructuring to accomplish this task?

I. ARE TRADITIONAL RESTRUCTURINGS DESTINED FOR EXTINCTION?

The first inquiry is really about the best method of maximizing asset value for the benefit of the creditors. It proceeds from the basic idea that a restructuring is an appropriate response only if the creditors are able to obtain at least as much as they would in respect of a liquidation.[1] Some believe that the traditional restructuring is no longer able to outperform a going concern liquidation of the firm. The argument, so it goes, is that the world has changed, and that asset sales are now much more likely able to yield more than can be obtained through keeping the firm intact. How has this come about? It is claimed that this shift has occurred because the types of assets held by firms have changed and markets

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1. The classic statement of this principle is found in *Lehndorff General Partner Ltd., Re* (1993), 17 C.B.R. (3d) 24 (Ont. Gen. Div. [Commercial List]), at para. 7 in which Farley J. stated:

> One of the purposes of the CCAA is to facilitate ongoing operations of a business where its assets have a greater value as part of an integrated system than individually. The CCAA facilitates reorganization of a company where the alternative, sale of the property piecemeal, is likely to yield far less satisfaction to the creditors.

In *Ted Leroy Trucking Ltd., Re* (2010), 326 D.L.R. (4th) 577, 2010 SCC 60 (S.C.C.). at para. 77, Deschamps J. recognized that "participants will measure the impact of a reorganization against the position they would enjoy in liquidation."

have changed. Assets have become more fungible and less firm-specific so that there is less going concern value.[2] Markets are more liquid so that even when there is going concern value the whole enterprise can be sold off.[3]

Clearly, there has been an escalating use of the Companies' Creditors Arrangement Act[4] (CCAA) as a vehicle for effecting asset sales.[5] But we cannot conclude from this alone that the traditional restructuring is on the road to extinction. We cannot assume that a traditional CCAA restructuring would have been commenced in each of these cases had the courts been less receptive to liquidating CCAAs. The increase may be due to the fact that liquidations that normally would have been undertaken pursuant to receivership or bankruptcy proceedings are now being effected under the CCAA. This migration of liquidations has occurred in the past — most notably when a concern over the liability of insolvency professionals resulted in a shift away from receivership proceedings.[6] To get a complete picture, we would need to compare over a period of years the total number of traditional restructurings (under both the CCAA and the commercial proposal provisions of the Bankruptcy and Insolvency Act[7] (BIA)) as against the total number of liquidations (pursuant to bankruptcy and receiverships proceedings as well as liquidations effected through the CCAA or Division I of the BIA). Are liquidations simply migrating to the CCAA from other insolvency regimes? Or are traditional restructurings being replaced with liquidations? One suspects that the answer is that both factors are in play, but we do not know if one dominates over the other.

Even if we were convinced that there has been a significant shift in favour of liquidations, we could still not be certain that value to creditors is being maximized by asset sales. There are alternative (and darker) theories that might explain this phenomenon. It could be that senior creditors have developed more effective strategies to prevent a beneficial restructuring that would yield greater value to

2. Douglas G. Baird and Robert K. Rasmussen, "The End of Bankruptcy" (2002), 55 Stan. L. Rev. 751; Douglas G. Baird, "The New Face of Chapter 11" (2004), 12 Am. Bankr Inst. L. Rev. 69.
3. Douglas G. Baird, "Bankruptcy's Undiscovered Country" (2008), 25 Emory Bankr. Dev. J. 1, at p. 7.
4. R.S.C. 1985, c. C-36.
5. Alfonso Nocilla, "Is 'Corporate Rescue' Working in Canada?" (2013), 53 C.B.L.J. 382.
6. See Roderick J. Wood, *Bankruptcy and Insolvency Law* (Toronto, Irwin Law, 2009), p. 465.
7. R.S.C. 1985, c. B-3.

the creditors as a group. Fully secured creditors typically prefer a liquidation to a traditional restructuring notwithstanding that the total value of the assets might be maximized in a restructuring.[8] Moreover, they will prefer a quick liquidation to a slower liquidation that yields greater value if the expected sale proceeds are sufficient to pay out their claim.[9] There is always a risk in a restructuring that the firm will not be able to turn itself around and that the cost and delay of the restructuring attempt will mean that the secured creditor will not receive full recovery of its claim. This risk is magnified given the wide use of court authorized super-priority charges such as those that secure the costs of administration, interim ("debtor-in-possession" or DIP) financing and the indemnification of directors and officers.[10] A senior creditor has a strong incentive to steer the insolvency towards a liquidation if it can. An increase in the relative number of liquidations may be an indication that senior creditors have been able to devise a number of devices and strategies that allow them to better exercise control over the insolvency proceedings.

There are two interrelated methods by which a secured lender can obtain control.[11] The first is through the use of contractual provisions in the financing agreements that are entered into after the restructuring proceedings are commenced. The business requires interim (DIP) financing in order to pay its post-restructuring obligations. In many cases, this financing is provided by a pre-existing secured lender. A secured lender can influence the direction of the insolvency proceedings by the use of negative and positive covenants in the interim (DIP) financing agreement.[12] These may set strict time-lines that make it less likely that a traditional restructuring can be achieved or that will limit access and use of cash flow. The agreements may also include events of default that effectively impose onerous financial stress tests that are difficult to satisfy.

The second method of gaining control is through influencing management of the business. The secured lender will often be able

8. Jason Berge, "An Efficiency Model of Section 363(b) Sales" (2006), 92 Va. L. Rev. 1639.
9. See, for example, *Royal Bank v. Vista Homes Ltd.* (1985), 57 C.B.R. (N.S.) 80 (B.C. S.C.), at para. 15.
10. CCAA, ss. 11.2(2), 11.51(2) and 11.52(2).
11. See Kenneth M. Ayotte and Edward R. Morrison, "Creditor Control and Conflict in Chapter 11" (2009), 1 J. Legal Analysis 511.
12. David A. Skeel, Jr., "The Past, Present and Future of Debtor-in-Possession Financing" (2004), 25 Cardozo L. Rev. 1905, at pp. 1916-1919; George W. Kuney, "Hijacking Chapter 11" (2004), 21 Emory Bankr. Dev. J. 19, at pp. 52-59.

to exercise control over the choice of management. For example, in the CCAA proceedings in respect of Crystallex International Corporation, the DIP loan stipulated that the board of directors was reduced to five, two drawn from the existing directors, two drawn from the DIP lenders, and one independent director agreed upon by the parties.[13] The secured lender will also be able to influence the compensation of the senior managers that remain. Key employee retention programs (KERPS) are established so that key personnel will be "incentivized to remain in their current positions during the CCAA process."[14] But KERPS may also have the effect of aligning the interests of the debtor's senior management with those of the secured lender.[15]

As a result, we encounter two diametrically opposed views of the world. The first is that CCAA liquidations are good because they are the most efficient way of maximizing aggregate recovery by the creditors. The second is that CCAA liquidations are bad because they are used by secured lenders to force liquidations in circumstances where a traditional restructuring would maximize aggregate recovery by creditors. This leads us directly to the next question. Why are we using a restructuring regime (the CCAA) to effect going concern sales when there are other insolvency regimes that are specifically designed for this purpose?

II. WHY IS THE CCAA USED FOR GOING CONCERN SALES?

The second critical question concerns the choice of insolvency regimes where liquidation is considered to be the preferred outcome. The CCAA, at first glance, does not seem to be a likely candidate for this role. The whole CCAA process is geared towards the development of a plan of arrangement that will be presented before the creditors for their acceptance or rejection. That this is the objective of the legislation is confirmed in the parliamentary debates, and in judicial statements at the highest level.[16] Indeed, the very title of the Act anticipates the negotiation of a consensual arrangement amongst the creditors and the debtor. The statute sets

13. *Crystallex International Corp., Re* (2012), 91 C.B.R. (5th) 207, 2012 ONCA 404 (Ont. C.A.), at para. 24, additional reasons (2012), 219 A.C.W.S. (3d) 61, 2012 ONCA 527, leave to appeal refused 2012 CarswellOnt 11931 (S.C.C.).

14. *Timminco Ltd., Re* (2012), 85 C.B.R. (5th) 169, 2012 ONSC 506 (Ont. S.C.J. [Commercial List]), at para. 75.

15. See Skeel, *supra*, footnote 12, at pp. 1922-1923; Kuney, *supra*, footnote 12, at pp. 74-90.

16. *Ted Leroy Trucking Ltd., Re*, *supra*, footnote 1, at paras. 15-18 and 70.

out rules as to the mandatory features of the plan of arrangement[17] and it contains rules for the classification of claims, voting, and court approval of the plan.[18] A liquidating CCAA severely truncates the insolvency process contemplated by the CCAA. The rules that govern the initiation of the process and the rules that keep the lights on and the creditors at bay are utilized, but those that deal with the attributes of a plan of arrangement and its approval by the creditors and by the court are all jettisoned.

It was hardly surprising, therefore, that courts initially took the view that receivership or bankruptcy proceedings were the more appropriate vehicle for liquidations.[19] As we know, this attitude has changed. Over the last decade, there has been an increasing willingness on the part of the courts to permit the restructuring regimes to be utilized for going concern liquidations of insolvent businesses. This idea was not uniformly embraced by courts across Canada. There was greater enthusiasm for liquidating CCAAs in Ontario, and perhaps Québec, than in British Columbia and Alberta.[20] The 2009 amendments to the CCAA now give the court the power to authorize a sale of assets, but the provisions do not provide much guidance on when it is appropriate for the court to exercise this power.[21]

The argument in favour of liquidating CCAAs is simply this: if using the CCAA process yields a greater return from the sale process than a bankruptcy or receivership, it is in the interests of all concerned that the CCAA be made available notwithstanding that the restructuring regime was designed for an altogether different purpose.[22] To critically assess this claim, we need to understand precisely why a sale process conducted under the CCAA is said to produce higher returns. Although bankruptcy often involves a piecemeal liquidation, receivership proceedings provide a mechanism specifically designed for going concern sales. So what features are available under the CCAA that are lacking in receivership

17. CCAA, s. 6(3)-(8).
18. CCAA, s. 6(1), ss. 22-22.1.
19. *Royal Bank v. Fracmaster Ltd.* (1999), 11 C.B.R. (4th) 230, 1999 ABCA 178 (Alta. C.A.).
20. Alfonso Nocilla, *supra*, footnote 5, at p. 394.
21. Alfonso Nocilla, "Asset Sales under the Companies' Creditors Arrangement Act and the Failure of Section 36" (2012), 52 C.B.L.J. 226, at pp. 243-247.
22. See *Anvil Range Mining Corp., Re* (2001), 25 C.B.R. (4th) 1 at para. 11 (Ont. S.C.J. [Commercial List]), affirmed (2002), 34 C.B.R. (4th) 157 (Ont. C.A.), additional reasons (2002), 38 C.B.R. (4th) 5 (Ont. C.A.), leave to appeal refused (2003), 180 O.A.C. 399 (note) (S.C.C.), in which Farley J. states that the CCAA is available if the process "would maximize the value of the stakeholders' pie."

proceedings that makes the former a better means for maximizing sale proceeds?

The CCAA process is a court-supervised process. It permits a court to approve super-priority interim (DIP) financing to pay for the ongoing costs of the business. It uses a court-appointed monitor to assist the court and to provide information to the creditors. These features do not explain the preference for CCAA proceedings. These features are all available in respect of receivership proceedings in Canada. A court-appointed receivership is a court-supervised process. The court routinely authorizes super-priority charges in relation to administrative costs as well as borrowings.[23] The receiver is an officer of the court and is under an obligation to act in the interests of all the parties.[24] The use of Chapter 11 to effect liquidations in the United States is more understandable.[25] They have no equivalent to the court-appointed receiver, and therefore Chapter 11 is the only process available outside of bankruptcy proceedings. But in Canada, we have an insolvency regime that was specifically designed for going concern sales of insolvent businesses. The fact that courts in CCAA proceedings are applying receivership law when dealing with liquidating sales clearly brings home the point that the processes used in CCAA liquidations are mimicking those in receivership proceedings.[26]

There is one major difference between the CCAA process and a court-appointed receivership. Unlike receivership proceedings, the CCAA uses a debtor-in-control model (as opposed to the insolvency professional-in-control model that prevails in a bankruptcy or receivership). While this is clearly desirable in a scenario where the company survives in some restructured form, it is difficult to see why this is a useful feature in respect of a liquidation. In truth, the CCAA process seems less likely to produce efficient outcomes.

23. *Robert F. Kowal Investments Ltd. v. Deeder Electric Ltd.* (1975), 59 D.L.R. (3d) 492, 21 C.B.R. (N.S.) 201 (Ont. C.A.). See also paragraphs 17 and 20 of the Ontario template receivership order (<http://www.ontariocourts.ca/scj/en/commerciallist/>) which creates a court ordered charge that secures the fees and costs of the receiver and another that secures the costs of borrowing and gives them priority over all other security interests.

24. *Ostrander v. Niagara Helicopters Ltd.* (1973), 40 D.L.R. (3d) 161, 19 C.B.R. (N.S.) 5 (Ont. H.C.).

25. See Stephanie Ben-Ishai and Stephen J. Lubben, "Sales or Plans: A Comparative Account of the 'New' Corporate Reorganization" (2011), 56 McGill L.J. 591.

26. The supervising judge in CCAA liquidations have routinely applied the principles developed in *Royal Bank v. Soundair Corp.* (1991), 83 D.L.R. (4th) 76, 7 C.B.R. (3d) 1 (Ont. C.A.). See, for example, *Nortel Networks Corp., Re* (2009), 56 C.B.R. (5th) 224 (Ont. S.C.J. [Commercial List]).

Although the monitor is an officer of the court, the monitor is also heavily involved in providing advice and direction to the debtor.[27] But if management of the debtor has changed, then the reality is that the senior creditor has obtained special access to the monitor — an advantage that is not available to any other creditor. By comparison, the duties that are imposed on a court-appointed receiver are better defined and more appropriate for a going concern sale. The court-appointed receiver has control over the management of the business and is bound to act in the interest of all the creditors.

The claim that the CCAA provides the better vehicle may ultimately rest on the vague assertion that CCAA provides for greater flexibility and that this is essential in proceedings that concern larger, more complex business entities. When the proponents of a liquidating CCAA claim that they need the greater flexibility of the CCAA process, a court should keep in mind that this so-called flexibility usually involves either a diminution of the private law rights of a third party[28] or the granting of a judicially authorized preference[29] usually in favour of commercially sophisticated and powerful creditors. These extraordinary powers were derived from the underlying public purpose of a statute which was based on the idea of rescuing a financially distressed firm. A much less compelling case for their use exists if the reality is that the CCAA process is being used by the senior creditor as a "unified foreclosure process" primarily for its own benefit.[30]

The supposed advantages of using the CCAA for liquidations must be weighed against other disadvantages. The CCAA was designed with the traditional restructuring in mind. Its substantive rules are geared towards the development of a plan of arrangement that will be presented before the creditors for acceptance or rejection. Many of these rules and processes are really not well suited for liquidation proceedings. Suppliers are given a reposses-

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27. See John I. McLean and David P. Bowra, "Conflicts and the Modern CCAA Monitor" in Janis P. Sarra, ed., *Annual Review of Insolvency Law 2011* (Toronto, Carswell, 2012), p. 479.
28. The CCAA has been invoked in order to seek an order for the assignment of contracts that ordinarily would require the consent of the counterparty. See S. Fitzpatrick, "Liquidating CCAAs – Are We Praying to False Gods?" in Janis P. Sarra, ed., *Annual Review of Insolvency Law 2008* (Toronto, Carswell, 2009), p. 33.
29. For example, a creeping roll-up DIP permits the payment of pre-filing obligations out of the post-filing revenues of the debtor. See Ray C. Rutman *et al.*, "Creeping Roll-Up DIP" (2012), 1 J. Insol. Inst. Can. 161.
30. See Kuney, *supra*, footnote 12, at pp. 24-25.

sory right over recent deliveries (30-day goods) in bankruptcy and receivership. A similar right was not conferred in respect of restructuring proceedings because it was thought to interfere with the rescue objective. Unpaid employees are treated differently in restructuring proceedings. Unpaid employees may make an immediate claim against the Wage Earner Protection Program Act[31] (WEPPA) insurance scheme in the bankruptcy and receivership proceedings. In restructuring proceedings, they must wait.[32] The procedural aspects are similarly designed with the traditional restructuring in mind. The debtor company is required to periodically return to court to seek to have the stay of proceedings extended. This gives the court the ability to assess if the debtor has made sufficient progress towards the development of a viable plan, and allows the court to terminate restructuring proceedings if the creditors are materially prejudiced or if the plan is doomed to fail. It was in this context that the court's consideration of public interest was often invoked. None of this is particularly relevant or useful in liquidation mode.

III. CONCLUSION

It may be that the train has already left the station and that liquidating CCAAS are here to stay.[33] This will make the life of the supervising judge all the more difficult. They are the gate-keepers who must decide in each case if the CCAA process is appropriate as a vehicle for going concern liquidation of the business. One hopes that they will not too easily succumb to empty platitudes about lower costs and greater flexibility in CCAA proceedings. They should demand and receive a convincing explanation why, in the particular case, the applicants believe that the CCAA process will be less costly and superior to receivership proceedings. They should inquire if the extraordinary powers that they possess — powers that represent a major intrusion into the private law rights of third parties — should be exercised for the benefit of a senior secured creditor. They should be alert to the fact that a senior creditor may

31. S.C. 2005, c. 47.
32. Although payments of past amounts due to employees who continue to be employed by the debtor are typically authorized, the position of employees who are laid off as a result of downsizing is more precarious.
33. In Alberta, where *Fracmaster, supra*, footnote 19, had dampened the use of liquidating CCAAS, the initial indication is that s. 36 of the BIA is interpreted as authorizing sales of substantially all the assets without the need for a plan of arrangement. See *Fairmont Resort Properties Ltd., Re*, 2012 ABQB 39, at para. 26.

well be calling the shots, and that the apparatus of the CCAA that was designed for traditional restructurings may not be well suited for a liquidation. They should not be too quick to authorize a sale without the input of the creditors who rank below a senior secured creditor whose claim is expected to be fully satisfied from the sale proceeds.[34]

34. See *Fairmont*, *supra*, in which the court approved a liquidating CCAA without a plan or formal vote of creditors, but was influenced by the fact that the sale was supported by the undersecured affected creditors.