12 October 2005

POSITION PAPER

BILL C-55

INTRODUCTION

The Insolvency Institute of Canada ("IIC") is Canada's pre-eminent private sector insolvency organization. IIC is a volunteer non-profit organization dedicated to the recognition and promotion of excellence in the field of insolvency. Its members are drawn from the most senior experienced members of the insolvency community in Canada. Membership is by invitation and is limited to 125 insolvency practitioners (lawyers, trustees and financial advisors) who are joined by prominent members of the academic community and by representatives of regulatory and compensation bodies and of major financial institutions.

IIC has been campaigning for reform of Canada's insolvency statutes for years, particularly with respect to business insolvencies. The statutes have become more and more out-of-date and the pace of change is accelerating. Out of concern for the national interest, the members of the IIC devoted substantial volunteer efforts over the past 5 years to develop numerous specific proposals for reform.

Accordingly, IIC welcomes the provisions of Bill C-55 that are intended to modernize the CCAA and the commercial provisions of the BIA. IIC believes that many of the provisions of Bill C-55 contain positive and constructive reforms.

However, IIC has three general concerns about Bill C-55.

Checks and Balances

Bill C-55 adopts a number of reforms to commercial insolvency law that IIC has championed since 2001. However, in doing so a number of important checks and balances that formed a critical part of our reform proposals have been overlooked. Bill C-55 should be amended to include them.

Ineffective/Unintended Effects

In certain areas, the mechanics of the way that the provisions of Bill C-55 implement certain policy objectives will be ineffective or incomplete, or will have unintended and unnecessary effects that will be adverse to the national interest. As practitioners who deal with the insolvency system on a daily basis and understand how it works in practice, those effects are of concern and Bill C-55 should be amended accordingly.

Narrow Scope

The commercial provisions of Bill C-55 are limited in scope. IIC submits that either the Bill should be amended to broaden the reforms, or at a minimum the 5-year review should be abbreviated to 3 years. Otherwise, experience suggests that new legislation addressing important areas of reform may be significantly delayed.

PURPOSE

The primary purpose of this paper is to propose amendments to Bill C-55 that address the Checks and Balances and the Ineffective Unintended Effects issues. Our proposals are set out below on a conceptual basis.

In addition, the IIC has, jointly with Canadian Association of Insolvency and Restructuring Professionals, submitted two extensive reports to Industry Canada since March, 2002 that contain additional business insolvency law reform proposals that could be included in either an expanded Bill C-55 or future legislation. In addition, IIC and CAIRP have recently struck a joint task force that has provided commentary to Industry Canada on Bill C-55.

Finally, IIC has provided Industry Canada with a separate commentary on some drafting issues concerning Bill C-55, and a copy of that commentary is attached as Schedule 1.

PROPOSED AMENDMENTS TO BILL C-55

The proposals for amendments set out in this paper are based upon reform proposals that were the product of an extensive 5-year process involving working groups, background papers, task forces, extended debates and, ultimately, voting by the members of the IIC. They are put forward with very abbreviated explanations. We have not provided specific drafting language (other than for proposal 2), but would be pleased to assist in the process of translating the concepts into statutory provisions if that is of interest.

Interim Financing

Bill C-55 provides for the codification of the Court's power to authorize interim financing (also known as "DIP" loans) for businesses that file for reorganization under the CCAA or the BIA proposal provisions. IIC supports that codification. However, the IIC has also advocated certain checks and balances to the use of interim financing that are not included in Bill C-55. If these are not incorporated by amendments to the Bill, there is risk that the social and economic costs of interim financing will outweigh its benefits.

1. Amend the provisions that give the Court authority to prime an existing secured creditor ("prime" meaning that the new security for interim financing is given priority over existing security) (a) to prohibit priming without prior notice to the affected secured creditor in all cases, and (b) provide that in deciding whether to exercise the authority to prime, the Court should use the existing balancing of prejudices/limited prejudice test developed by the Courts when exercising inherent jurisdiction.

Bill C-55 authorizes a Court to provide that the security for interim financing primes all or such pre-existing security as the Court may specify. The IIC supports this authority, but on the basis that prior notice must be given to the affected secured creditors and that the priming must be justified under the existing "balancing of prejudices/limited prejudice" test developed by the Courts. IIC is concerned that in the absence of these requirements there may be an increased risk that the power to prime will:

(a) make it harder and more expensive for successful Canadian businesses to obtain secured loans; and,

(b) make it easier for incompetent or dishonest management to misuse or abuse the reorganization system.

2. Amend the proposed fourth factor to be considered by the Court in authorizing interim financing to read "whether the interim financing will enhance the prospects for a going concern solution or rehabilitation through a reorganization or sale that would create more value than a liquidation" and add an additional factor "whether the interim financing is necessary for the continuation of the business operations of the debtor or the preservation of its assets".

Bill C-55 requires the Court to consider certain factors when deciding whether or not to authorize interim financing. These factors are not conditions precedent, so the Court can decide to authorize the interim financing even if the factors are not satisfied. But the factors assist the Court in evaluating an application for interim financing and any objections to it.

IIC believes that it is important to include the two factors described above in the list of factors in Bill C-55. These additional factors reflect important considerations that are relevant to any contested application for interim financing. They are as important as, or more important than, the factors listed in Bill C-55.

3. Add a clarifying requirement that the charge for the interim financing can only secure new loans made after the commencement of the proceedings.

This provision would prevent pre-filing creditors from using interim financing to obtain an unfair preference over other creditors.

Governance

The trend over the past 25 years has been to give the debtor more and more tools to try to address financial difficulties. IIC supports that general trend which is reflected in many of the provisions of Bill C-55. The social justification for those new tools is that finding going concern solutions and avoiding the economic and social costs of outright liquidation can be an economic and social benefit to Canada. But that assumes that the new tools are used wisely for the right purposes. The development of those new tools, and the additional powers they give a financially distressed business, put a premium on proper governance of the debtor, an issue that is not presently addressed by Canadian insolvency legislation.

4. Amend the provisions authorizing the Court to remove directors of a corporation attempting to reorganize to provide that the Court has the discretion to act if the governance of the debtor is impairing or could impair the process of developing and implementing a going concern solution.

Bill C-55 authorizes the Courts to remove and replace directors of corporations that file for reorganizations under the CCAA or the BIA. IIC supports that authority, but recommends that the criteria to be applied by the Court be refocused. Bill C-55 articulates a test which could be

interpreted as a "bad apple" test, focused on the bad conduct or potential for bad conduct of an individual director. IIC is more concerned about structural issues. For example, most Canadian corporations that file for reorganization have a controlling shareholder or shareholder group. Experience suggests that the success of the restructuring proceedings may depend on the controlling shareholder turning over control of the restructuring process to independent parties at an early state of the proceedings.

5. Require the Court to assess whether appropriate governance mechanisms have been established for the debtor during the restructuring proceeding such as establishing an independent board committee or retaining an independent chief restructuring officer.

IIC submits that it is important to encourage the board, management and the advisors of the debtor to address governance issues before and during a restructuring proceeding, by mandating the Court to assess the governance structure. One specific mechanism could be to require that factor to be assessed by the Court when initially granting the stay and/or on stay renewals.

6. Provide for a general due diligence defence for directors and officers with respect to personal statutory liabilities incurred during the course of a reorganization proceeding.

It is important to encourage good directors not to resign from boards of financially troubled corporations, and indeed to join them either before or during a reorganization proceeding. The purpose of amendment 6 is to encourage directors to stay involved during a reorganization proceeding.

7. Provide that the debtor's independent directors have protection from personal statutory liability otherwise arising from the debtor's failure to pay pre-filing obligations so long as the debt is not more than seven days overdue at the time of commencement of a CCAA or BIA proposal case.

The purpose of amendment 7 is to encourage independent directors not to resign if a company is in the vicinity of insolvency. That amendment would make it clear that so long as a company was up to date with its employee payments and government remittances, the independent directors would not be at risk, and if the company runs out of money and cannot pay, they would have no more than seven days to get the company filed for reorganization.

8. Empower the Court to appoint an interim manager to replace management in the conduct of a reorganization proceeding.

In a number of situations, creditors have supported a company's efforts to reorganize but have not supported existing management. On occasion, an interim receiver has been appointed to run the restructuring proceeding. Bill C-55 contains technical amendments that would make that more difficult or impossible. IIC advocates the Court having authority to appoint an interim "manager" to run the restructuring proceeding where it is appropriate to restructure, but unhelpful to have existing management run the restructuring.

Insolvency Administrators

9. Provide that monitors, proposal trustees, interim managers, receivers and trustees in bankruptcy are not personally liable as successor employers, or for the new statutory charges for wages and pension contributions.

Imposition of personal liability of insolvency administrators for employee claims has the exact opposite of its intended effect. It puts employees at risk rather than protecting them. Where there is no material risk that there will not be a going concern solution, imposing personal liability is unnecessary and of no benefit to the employees. When there is a material risk of a shut down liquidation, it discourages insolvency administrators from attempting to rescue the business. In those circumstances, personal liability encourages an immediate shut down liquidation which harms the employees.

Executory Contracts

Bill C-55 provides for a general scheme for dealing with ongoing or "executory" contracts in insolvencies. IIC supports the introduction of such a scheme to Canadian insolvency laws. However, there are a number of enhancements required to the draft scheme.

10. Require that before disclaiming an executory contract (rather than exercising any other rights of termination the debtor may have), the debtor must obtain either the approval of the monitor or the proposal trustee, or Court approval.

To prevent favouritism to parties related to the debtor and other abuses, the power of the debtor to disclaim contracts should be subject to the prior approval of either the monitor or proposal trustee, or the Court.

11. Provide that the disclaimer of an executory contact does not affect any property rights already acquired by the counter-party, such as the right to use personal property leased from the debtor during the term of the lease or to retain the ownership of property when title has passed before the disclaimer.

It is important to be clear that the disclaimer of an executory contract does not trigger a loss of property rights acquired under the contract before it is disclaimed.

12. Remove the requirement that if the debtor disclaims a contract and the counter-party objects, the debtor must satisfy the Court that the disclaimer is necessary for a viable plan of arrangement or proposal, and replace it with a requirement that the debtor give an explanation of the business reason for the disclaimer.

Bill C-55 provides that if the debtor proposes to disclaim a contract, the counter-party can require the debtor to prove that the disclaimer (together with the disclaimer of all other contracts being disclaimed) is necessary in order for a reorganization to be viable. In practice, this is a test that cannot be effectively litigated in a Court because it involves numerous hypothetical possibilities. It is also a restriction on the power of disclaimer that is as unnecessary as it is

unworkable. Subject to the restrictions contemplated by proposed amendment #10, the business decisions about which contracts to keep and which to disclaim should be left to management.

13. Provide in both the CCAA and the BIA, that in order to assign an executory contract all payment defaults be cured (rather than all defaults or all financial defaults).

IIC supports the codification of the power to assign (or sell) most executory contracts in an insolvency proceeding. IIC also supports the principle that any overdue payments owed to the counter-party be paid as condition of the assignment. However, Bill C-55 goes further in requiring a variety of non-payment defaults to be cured, which could render the power to assign useless in practice. For example, if Bill C-55 is enacted without amendment lawyers will attempt to draft contracts so that it is not possible to cure all defaults after an insolvency.

14. Provide that in a reorganization proceeding, the Court shall have the power to stay the legal set-off of pre-filing claims against post-filing obligations of the creditor, and the counter-party to an executory contract should have the right to set off pre-filing claims against pre-filing obligations but not against post-filing obligations.

Amendments to the CCAA in 1997 have been interpreted as limiting the power of the Court to stay set off rights. For example, it may now be the law that if a debtor deposits money with its bank after filing for reorganization that the bank can set off the money against pre-filing loans. This risk creates very real practical difficulties for debtors attempting to restructure, and potential unfairness to other creditors in restructurings. This set-off issue should be addressed as a necessary part of the introduction of the overall scheme addressing executory contracts.

Collective Bargaining Agreements

15. Subject to significant specific limiting pre-conditions, including failure of collective bargaining to reach a conclusion within a reasonable time period, provide that the Court should have the power similar to a U.S. bankruptcy court to impose modifications of collective bargaining agreements, or provide for some alternate mechanism that would ensure finality on a timely basis.

IIC supports a process that promotes a renegotiation, where necessary, of any collective bargaining agreement through conventional collective bargaining processes. However, there must be a mechanism, such as exists under U.S. laws, for a Court or other authority to impose a resolution if collective bargaining fails to achieve a successful result within a reasonable period of time. Otherwise, unionized companies, particularly mid-size companies, will be at a greater risk of being liquidated rather than reorganized.

Income Trusts/Securitizations

16. Provide that trusts other than income trusts are also eligible for liquidation under the BIA, but are not eligible to be reorganized by way of a BIA proposal or under the CCAA.

IIC supports Bill C-55's inclusion of income trusts in the types of entities that can reorganize under the CCAA or the BIA proposal provisions. However, there is currently a gap in the legislation and it is unclear how other insolvent business trusts should be dealt with. Since these are generally used as special financing vehicles (rather than to run operating businesses), IIC recommends that other business trusts be permitted to liquidate under the BIA (but not be reorganized).

International Insolvencies

Canadian insolvency legislation already has a scheme for recognizing and co-ordinating with foreign insolvency proceedings. That scheme works well. Indeed there are no cross-border insolvency arrangements that work better than current Canada/U.S. arrangements. Accordingly, there is a real risk that the new scheme contained in Bill C-55 and based upon the UNCITRAL Model Law will actually be a step backwards. IIC proposes two amendments that are intended to mitigate that risk.

17. **Provide that as a condition of recognizing a foreign proceeding, the Court should appoint either a monitor or a local creditors' committee to represent the interests of local creditors in the foreign proceeding if there is not a full proceeding in Canada, with the costs thereof being paid by the estate.**

The purpose of this proposal is to ensure that the interests of Canadian creditors are not ignored if there is not a full insolvency proceeding in Canada. The requirements of proposal 17 should either be mandatory, or a general principle with the Court having a residual discretion to forego the requirements where there are minimal Canadian creditors and assets.

18. **Provide that the recognition of a foreign proceeding as a foreign main proceeding, does not in and of itself limit or prohibit the right to bring or continue a full CCAA or BIA proposal proceeding with respect to the same debtor.**

The purpose of this proposal is to preserve the flexibility to have a full proceeding in Canada when there is a full proceeding in the United States. That flexibility is one of the reasons why the current Canadian/U.S. cross-border reorganization scheme is effective. It is possible that Bill C-55 would restrict that flexibility, particularly if creditors seek a full Canadian proceeding.

Equity Interests

19. **Provide that (a) the new provisions concerning the treatment of debt claims related to equity be extended to apply to claims relating to redemption of shares, unpaid dividends and rights of indemnity for damages based on the purchase or sale of a share or unit of the debtor, (b) that a plan or proposal can compromise such debt claims relating to equity without the approval of applicable claimants, and (c) that the Court approving a reorganization plan has the power to approve a reorganization of the equity of the debtor, either with or without shareholder approval.**

The failure to have a scheme to deal with equity claims and interests is one of the important ways that Canada's current insolvency laws are out-of-date. Bill C-55 contains provisions that deal

with equity claims in part. Those provisions are inadequate and will be largely ineffectual unless amended as proposed above.

<u>Statutory Charges For Wages and Pension Contributions</u>

IIC is very concerned that the creation of additional statutory charges will make it more difficult and more expensive for Canadian businesses to obtain secured financing. Many significant Canadian businesses depend upon secured financing. Restricting access to that type of funding will hurt the competitiveness of the Canadian economy and hurt employment.

Bill C-55 proposes to create charges securing wage and pension contribution arrears that are owing at the outset of an insolvency proceeding. IIC has been advised that on a national basis the aggregate amount of money involved is not large. If, as a social policy matter, it is decided that this issue should be addressed, then it is important to do so in a way that will not be indirectly much more socially expensive.

20. Replace the proposed definition of working capital with a definition that refers to "inventory, accounts receivable owing for the sale of inventory or the provision of services and cash or cash equivalents that are identifiable proceeds of inventory or such accounts receivable", and provide that both the new pension contribution charge and the new wages charge, as well as the existing deemed trusts for source deductions, apply only to such working capital assets but in priority to other security interests on such assets.

IIC submits that the amendments proposed by IIC will not impair the social policy objectives of the wage earner protection scheme. With these amendments, the proposed new statutory charges should not have the significant indirect costs of hurting productivity, growth and employment.

<u>Transfers at Undervalue</u>

IIC supports the provisions of Bill C-55 that creates the new anti-avoidance regime for attaching "transfers at undervalue". IIC proposes four technical amendments to ensure that the new scheme works as intended.

21. The new "transfers at undervalue" provision should be amended to:

- **(a) apply also to the incurrence of obligations and other transactions where the debtor's estate was conspicuously depleted by the transaction, as well as applying to conveyances of property and the provision of services;**
- **(b) be available in CCAA proceedings as well as under the BIA, and be exercisable by the monitor or by creditors pursuant to a provision modelled after s.38 of the BIA (but without limiting the power of the monitor to settle the claim, subject to due process);**
- **(c) provide that the remedies available with respect to a transaction at undervalue involving a transfer of property by the debtor include recovery of the transferred property or its proceeds; and,**

(d) **define “privy” as a person that is not at arm’s length with one of the parties to the transaction and who received a share of the improper benefit from the transaction.**

30-Day Goods Preference

22. Either repeal the 30-day goods preference in favour of goods suppliers or leave the existing provisions unamended.

IIC is concerned that the existing 30-day special statutory priority for goods suppliers already hurts the Canadian economy. IIC’s position is that those provisions should be repealed outright.

Wage Earner Protection

It is a social policy question whether or not to provide a wage earner protection scheme. The formal studies on the issue in Canada over many years have consistently concluded that a fund (rather than statutory liens or other mechanisms) is the best mechanism to use if the decision is made to provide additional protection for wages in insolvencies.

The IIC therefore only has some practical and technical comments concerning the proposed scheme.

23. Amend the mechanics of the wage earner protection provisions to give a receiver or trustee in bankruptcy the option of simply paying the outstanding wages and vacation pay rather than arranging to have the employees claim against the fund, and upon such payment receiving an assignment of the statutory charge and of any claims against directors (but not against the fund).

In most existing business insolvencies, wage arrears are simply paid according to the normal payroll cycle. The statutory provisions should facilitate the continuation of that practice, not discourage it.

24. Amend the mechanics of the wage earner protection provisions to provide that reasonable administrative costs of compliance by insolvency administrators will be reimbursed by the federal government as part of the costs of the program.

In marginal situations where it may be necessary to utilize the fund, compliance costs will become a material issue. The risk is that the assets may have limited realizable value either before or after payment of secured claims, and that no private sector party will want to pay for the compliance expenses. If so, no insolvency administrator will be appointed, the business will be abandoned, and there will be no compliance.

25. Remove the offence provision applicable to insolvency administrators.

For the reasons described earlier in this paper, imposition of personal liability will simply encourage the abandonment of marginal businesses. The result will be to increase the calls on the compensation fund.

CONCLUSION

IIC welcomes the introduction of Bill C-55. However, its enactment will have many indirect as well as direct effects. It should be amended in the national interest to ensure those effects are socially and economically positive, and promote growth and prosperity.

Schedule 1

Drafting Suggestions

CCAA and BIA

1. There should be no differences between the wording of parallel provisions of the BIA and the CCAA (other than conforming changes such as "proposal trustee" and "monitor") unless there is an underlying policy reason for the difference. Examples include provisions dealing with:

   a. interim financing;

   b. timing of payment of pension amounts under a BIA proposal and CCAA plan;

   c. the enforceability of collective agreements on the commencement of a restructuring proceeding under either the BIA or CCAA; and

   d. the test to be considered by the court prior to authorizing an assignment of an agreement under the BIA and CCAA.

National Receivers

2. New section 243(1) should be amended by adding at the end thereof the words "and to take such other action as the court considers advisable".

Disclaimer of Executory Contracts

3. Make it clear that the power to disclaim executory contracts is in addition to, and does not limit, any other right the debtor may have to terminate a contract under its terms or under general legal principles.

4. Bill C-55 lists certain types of contracts that cannot be disclaimed in a BIA proposal or CCAA proceeding. One of the exceptions is for "a financing agreement if the debtor is the borrower". The term "financing agreement" is not defined, but could include a security agreement. Taken literally, this wording would allow the disclaimer of a security agreement provided by a guarantor or co-obligor that is not the borrower, and might permit the disclaimer of a finance lease by a lessee. This exception should be modified to refer to financing agreements, including security agreements, where the debtor is the borrower, lessee or obligor.

Wage and Pension Contribution Charges

5. It should be made clear that if there is both a bankruptcy and a receivership for the same entity that the new statutory charges for wage and pension contribution arrears do not double up, and that the liens apply to proceeds net of reasonable recovery costs and prior claims.

CCAA Claims

6. The new s.19(1) could well be construed so that the CCAA does not apply to a variety of contingent claims which would be a major step backwards. We are unclear of its purpose and suggest it be removed from the legislation.

Classification of Creditors

7. An additional factor in classifying creditors should be the terms of the proposed plan of arrangement.

Ranking of Court-Ordered Charges

8. It should be clear that the Court has the authority to rank the relative priority of the charges created by the Court and to determine which assets are subject to those charges.

Plan Approvals

9. Specify in the provisions governing monitors and proposal trustees, that in order to approve a reorganization plan or a proposal, the Court must receive a report from the monitor or the proposal trustee opining that it is reasonable to expect that any dissenting creditor will not receive less under the plan or proposal than it would receive in a liquidation.