IN VOLU NTARY CREDI TORS AND CORPO RATE BANKRUPT CY

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AGENDA

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BACKGROUND & OVERVIEW

- Growing trend of selling a corporate debtor’s assets quickly before considering a plan of reorganization
- Growth of secured credit means that a priority claim often becomes little more than a token with no real value
- Involuntary creditors are particularly suffering as a result of these quick sales
- These quick sales are often used to cleanse assets of their association with environmental claims (environmental creditors represent one type of involuntary creditor)
Costs for environmental remediation are secured by a security interest on the real property affected; this interest has superpriority status over any other claim, right, charge, or security against the property (outlined in the BIA and CCAA).

This essentially creates a governmental superlien on the debtor’s property and provides environmental creditors with better priority status than they otherwise would have received.

Under this scheme, the environmental damage may occur before or after the date that the debtor files for bankruptcy.
The *BIA* and *CCAA* provisions reflect the “polluter pays” principle entrenched in federal and provincial incorporation legislation.

The trustee in bankruptcy or the *CCAA* monitor may abandon environmentally damaged property and, if done, the monitor is not required to comply with a remediation order.

Trustee or monitor is not personally liable for environmental damage that occurred before or after their appointment (except in cases of gross negligence or misconduct).

*Re General Chemical Canada Ltd* established that the power of the government to make environmental orders in the context of a bankruptcy is limited.
The debtor’s liability for past cleanup work conducted by somebody else is a general unsecured claim that can be treated as such during the reorganization case.

However, orders directing the debtor to clean up property are typically not considered claims and are not discharged at the end of the debtor’s case (this can apply to property that the debtor owned in the past but no longer owns by the time of bankruptcy).

The abandonment of contaminated property in liquidation is prohibited.
The Canadian approach appears to favour past cleanup, while the American approach is better suited to protect unaddressed contamination. However, there are several complicating factors. The Canadian superpriority lien is simply that – a superpriority on contaminated property. The ability to foreclose on such a property is highly questionable. The inability of a liquidating American debtor to abandon contaminated property is of little consequence if the debtor has no ability to pay to clean up the property. Essentially, the effectiveness of these protections turns on the debtor’s need for the contaminated property and the environmental creditor’s ability to turn that need into leverage in the reorganization process.
Both the BIA and the CCAA establish that environmental claims constitute “provable claims” in bankruptcy.

A claim against the debtor for the costs of remedying environmental damage shall be a provable claim, regardless of whether or not it occurred before or after the date of the filing.

Canadian courts have held that environmental clean up costs can be compromised during the restructuring process and therefore do not have to be paid in full before a plan of arrangement or compromise can be approved by the court.

The court’s insistence that environmental claims be treated as any other financial claims hints that these claims would also be discharged in the same manner as other financial claims.

**Newfoundland and Labrador v AbitibiBowater Inc**
ENVIRONMENTAL “CLAIMS” IN THE US

- 30 years of litigation tells us that the prebankruptcy obligations to pay for past cleanup are dischargeable, so long as the discharge comes after the enactment of the relevant environmental statute, while the duty to comply with environmental regulatory laws and clean up currently contaminated property is not dischargeable.

- Nondischargeability of environmental orders means that orders to clean up property can continue to be enforced during and after the reorganization case.

- The duty to remediate may be entitled to be characterized as an expense of administering the reorganization; such expenses must be paid in full, in cash, before a reorganization plan can be confirmed.
SALE AS A DISCHARGE SUBSTITUTE

- If a debtor stays largely intact during its reorganization, the scope of its discharge at the end of the Chapter 11 or CCAA process is key; however, if the debtor sells most of its assets, discharge wanes in importance.

- If the debtor can create a new entity to buy its assets, the distinction between “normal” reorganization and sales vanishes from an operational perspective, and the only question is which process better rids the assets of past errors, thus maximizing their value.

- Outside of reorganization, an asset sale does not generally result in a transfer of liabilities, unlike a merger.
SALE AS A DISCHARGE SUBSTITUTE

- Thus, in the Chapter 11 or CCAA sale context, the vital feature of reorganization law is the ability to sell assets free and clear of claims to the buyer.
- This includes protection from the environmental claims that the debtor owes, so long as the purchased assets do not include contaminated assets.
- General Motors sold its “good” assets to the newly created GM and thus its surviving business is now free of any obligations from its formerly owned contaminated properties.
- As long as the debtor company does not sell its contaminated property, it is possible for a debtor subject to environmental claims to affect the sale of its assets, largely free and clear of charges, liens and restrictions.
- AbitibiBowater and General Chemical Appeal.
ADJUSTING TO THE NEW REALITY

- If debtors increasingly turn to quick sales, then the strategies designed to exempt environmental claims and other involuntary debt claims from the bankruptcy or insolvency process are no longer viable.
- Involuntary creditors will increasingly have to work within the insolvency system to protect their interests.
- Any attempt by the judiciary to continue to operate under the old regime will distort the current framework and have significant implications for the lending market, as well as the ultimate objective of maximizing the value available to all creditors.
PROHIBIT QUICK SALES?

- Traces back to the US *Bankruptcy Act* of 1867; preplan asset sales were only permitted in cases involving debtors with inventory of dairy products or vegetables or where some other similar factor prevented the debtor from selling the assets as part of a full plan.

- A rule prohibiting quick sales may make sense if we assumed that most of the current quick sales are substitutes for full reorganization cases; if, however, many quick sales are substitutes for liquidations, the desirability of such a rule becomes rather suspect.

- The solution of preventing quick sales is unlikely to prevail; instead, creditors, including involuntary creditors, must adapt to this new reality.

- The reorganization process must also adapt to ensure that the process is being used to maximize the value of the debtor’s assets and not merely to transfer wealth among claimants.
HOW DOES A SALE AFFECT INVOLUNTARY CREDITORS?

1. Reduction of holdout powers
2. Lost value to involuntary creditors
3. Efficiency (this issue is not specific to involuntary creditors)
SUPERPRIORITY AGAINST ENTIRE ENTERPRISE?

- Does Canada’s superpriority claim go far enough?
- Perhaps the superpriority claim needs to be against the debtor’s enterprise, rather than the specific piece of contaminated property.
- Broad notions of enterprise liability are probably more apt to be academic than real, particularly given the threat that this argument would post to asset-backed securitization.
- Banks and other financial institutions would argue that this discourages lending to companies that have any connection to environmental pollution.
- This expansion would address the issue of debtors transferring value from environmental claimants to senior lenders, but would not address the problem of debtors who sell their assets too cheaply.
POSSIBLE RESPONSES

1. The monitor or the US creditor committees may be a proxy for the lost voice of involuntary creditors. In addition, representative counsel, appointed by the court and paid for by the estate of the debtor, may fulfill this role.

2. The requirement of an auction in “nonemergency” situations to ensure that value is not lost that could potentially have gone to the involuntary creditors.

3. The requirement that public interest is considered in the section 36 sale process test may serve as an example of how externalities and broader efficiency-related issues may be considered at an early stage in the process.