FAIR AND REASONABLE:
THE TREATMENT OF EQUITY CLAIMS UNDER THE CCAA

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INTRODUCTION

The *Companies’ Creditors Arrangement Act*\(^1\) should be applauded for facilitating the flexible restructuring of insolvent companies in Canada. However, the skeletal nature of the Act that provides this flexibility has also given rise to uncertainty in insolvency proceedings. One question that surfaces during a restructuring under the CCAA is how to deal with the existing shareholders of an insolvent corporation. The CCAA itself is not equipped to alter the rights of shareholders. However, the Act specifically provides that it may be used in conjunction with any other statute that authorizes an arrangement or compromise between a company and its shareholders.\(^2\) In addition, recent amendments to the CCAA allow the court to sanction a plan of compromise voted on only by non-equity claimants.\(^3\) Courts are also restricted from sanctioning any plan that provides for the payment of an equity claim unless all other claims are paid in full.\(^4\) In application of these provisions, courts have vehemently allowed the elimination of shareholders’ rights by applying the CCAA in conjunction with Canada’s corporate statutes. This paper will provide a brief analysis of this jurisprudence. It will then comment on why this development should be regarded as a victory for insolvency law and economic efficiency in Canada.

I. JURISPRUDENCE

A court’s role on a CCAA sanction hearing is to consider whether a plan of compromise fairly balances the interests of all stakeholders. A plan must also be weighed against the consequences of the alternative; liquidation. When voting on a plan, creditors are asked to accept compromises since liquidation would result in a greater shortfall in the payment of their claims. Shareholders however, are asked to accept the total elimination of their interest in either scenario. There is no benefit to the shareholder to

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\(^1\) RSC, 1985, c C-36 [“CCAA”].
\(^2\) *Ibid*, s 42.
\(^3\) *Ibid*, s 6(1). Subject to the plan satisfying the three part test articulated in *Re Northland Properties Ltd* (1988), 73 CBR (NS) 175 (BC SC) at 182-3, aff’d (1989), 73 CBR (NS) 195 (BC CA).
\(^4\) *Supra*, note 1, s 6(8).
vote in favour of a plan that provides for the total elimination of their interest. Thus, they are in a position where they have nothing to lose. In addition, if allowed to vote, they have the potential to gain if they are able to extort value from creditors under the threat of vetoing the plan. This could result in undue pressure on the creditors to offer incentives to shareholders in exchange for their cooperation. Courts have dealt with this issue by recognizing that the subordination of shareholders claims to those of creditors eliminates shareholders’ interests in an insolvent corporation. In Re Canadian Airlines Corporation, shareholders refused to accept that their shares were valueless and sought to prevent the sanction of a plan that eliminated their interests. They argued that aspects of the restructuring had increased the value of the debtor company and in turn, the value of their shares. In rejecting the shareholders’ arguments, Paperny J. held

[w]here a company is insolvent, only the creditors maintain a meaningful stake in its assets. Through the mechanism of liquidation or insolvency legislation, the interests of shareholders are pushed to the bottom rung of the priority ladder. The expectations of creditors and shareholders must be viewed and measured against an altered financial and legal landscape. *Shareholders cannot reasonably expect to maintain a financial interest in an insolvent company where creditors’ claims are not being paid in full.*

The court went on to address the issue of whether shareholders should be allowed to vote on the plan of compromise. If shareholders do not maintain an interest in an insolvent corporation, it follows that they should not have a say in its future. The court reasoned that the rationale behind a reorganization that eliminates equity interests is plain; the corporation is insolvent and under liquidation the shareholders would get nothing. It is not unfair or unreasonable to allow the court to sanction a plan in these situations without shareholder approval. What would be unfair would be to permit the shareholders to have the ability to block a reorganization and destroy value that the creditors would receive under it. Madam Justice Paperny provided a useful summary of

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6 *Ibid* at para 143 [emphasis added].
7 *Ibid* at para 76.
The reasoning of the court in *Canadian Airlines* demonstrates the general position the courts have taken on the issues of the elimination of pre-existing shareholders’ interests, and whether those shareholders have the right to vote on an arrangement. The high water mark of the jurisprudence on these issues is the more recent case of *Stelco Inc. (Re)*, where Mr. Justice Farley masterfully applied the principles from *Canadian Airlines* discussed above. In *Stelco*, existing shareholders claimed that their shares had value on a going concern basis. The court was faced with the question: “does the equity presently existing in *Stelco* have true value at the present time independent of the Plan and what the Plan brings to the table?” The shareholders submitted that Stelco had substantial profits at times during the stay period and the market had responded with increases in the share price. They argued that the plan was not fair and reasonable because it provided for the elimination of their interests when there was more than enough value in Stelco to satisfy the claims of all creditors. If this had been true, then their claims would have merit, and the plan would have to consider their interests. Kevin McElcheran has pointed out that “[i]f, at the time of the sanction hearing, the business and assets of the debtor have a greater value than the claims of the creditors, a plan of arrangement would not be fair and reasonable if it did not offer fair consideration to the shareholders.” In hopes of realizing some value from their shares, the shareholders sought to have the monitor search for a potential purchaser for Stelco.

Justice Farley did not accept that Stelco was a healthy concern or that the shareholders maintained any interest in Stelco. In fact, he saw Stelco as a company that had been “wobbly” for some time and further, that it was only unusual market conditions

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8 *Ibid* at para 79.
9 See *Tea Corp, Cadillac Fairview, Loewen Group Inc (Re)*, (2001), 32 CBR (4th) 54 (Ont Sup Ct J) [Commercial List], *Campeau v Olympia & York Developments Ltd*, (1992), 14 CBR (3d) 303 (Ont Gen Div).
11 (2006), 17 CBR (5th) 78 [*Stelco: Sanction Order*] [emphasis added].
12 Kevin P McElcheran, *Commercial Insolvency in Canada* (Markham, Ont: LexisNexis Butterworths, 2005) at 290.
that had allowed it to avoid the looming liquidity crisis it had found itself in. During the sanction hearing, Justice Farley remarked “[t]he redness of the visage of Stelco is not a true indication of health and well being; rather it seems that it is rouge to mask a deep pallor.”¹³ The shareholders had overestimated the value of Stelco based on its performance during the stay period and thus had overestimated their interest. The court clarified that movements in the stock price are not indicative of a corporation’s health and further, that positive performance during the stay period does not necessarily mean a company is not massively insolvent. This reasoning must, of course, be applied on a case-by-case basis. In a case where a company is successfully in rehabilitating during the stay period, a careful examination should be performed before equity interest are eliminated. Situations may also arise when creditors seeks to eliminate shareholder interests when asset prices are depressed.¹⁴ Courts should be weary of these opportunistic creditors and apply the CCAA with the flexibility that it allows.

The court in Stelco went on to address the equity holders’ hopes of finding a private purchaser for Stelco. Justice Farley noted his agreement with one counsel’s analogy of the equity holders’ approach to “a desperation Hail Mary pass and the willingness of someone, without any of his own chips in the poker game willing to bet the farm of someone else who does have an economic interest in Stelco.”¹⁵ This demonstrates the decoupling that occurs when equity claimants have no economic interest in an insolvent company. In the end, the proposed plan, which eliminated the existing shareholder interests, was found to be fair and reasonable and was sanctioned by the court.

II. AMENDMENTS TO THE CCAA

The principles established in the cases discussed above led to amendments to the CCAA that clearly incorporated the historical treatment of equity claims. The

¹³ Supra note 17 at para 8.
¹⁴ See Enterprise Capital Management Inc v Semi-Tech Corp, 1999 CarswellOnt 2213, 10 CBR (4th) 133.
¹⁵ Supra note 17 at para 18.
amendments came into force on September 18, 2009 and lessened uncertainty when dealing with equity claims in a reorganization. Included with these amendments was the addition of definitions for the terms “equity claim” and “equity interest”. The prior absence of these definitions demonstrates the extent to which the CCAA was previously ill-equipped to deal with equity claims.16

The amendments included the modification of s. 6(1) and the addition of s. 22.1. With these two changes, the question of whether existing shareholders are entitled to vote on a plan of compromise and arrangement is put to rest. Further, by allowing the court to order otherwise, parliament has built in protection for rare circumstances where unfairness would result if shareholder votes were not considered. The interpretation of these sections makes it clear that the default setting in a restructuring under the CCAA is for equity holders not to have any right to vote on a plan of arrangement.

Another relevant amendment to s. 6 was the addition of s. 6(8). This provision places the restriction that no compromise or arrangement that calls for a distribution to an equity claimant is to be sanctioned by the court unless all other claims are fully satisfied. This removes any judicial discretion on the matter. The drafting of this section makes it very clear that equity holders are on the bottom rung of the priority ladder and should not receive any value until all non-equity claims have been fully satisfied. This amendment can be viewed as codification of the principle discussed above as it was applied in Canadian Airlines and Stelco.

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16 It should be noted that the breadth of the definition of “equity claim” under the CCAA seems to encompass all types of claims that are derivative of an equity interest, including claims that might otherwise considered to be in the nature of a debt, e.g. indemnity claims and declared but unpaid dividends. See Nelson Financial Group Ltd, Re, 2010 ONSC 6229, 71 CBR (5th) 153; and Return on Innovation Capital Ltd v Gandi Innovations Ltd (2011), 2011 ONSC 5018.
III. THE CURRENT TREATMENT IS FAIR AND REASONABLE

In a sanction hearing under the CCAA, one of the general principles to be applied in the exercise of the court’s discretion is that the plan must be fair and reasonable.\(^{17}\) The cases discussed above have evidenced that the requirement of fairness and reasonableness is paramount in the court’s final decision on whether to sanction a plan of arrangement. Section 6(8) of the CCAA makes it unnecessary for courts to consider the question of fairness and reasonableness of a plan that provides for some payment to equity holders. However, a discussion of the reasons why such a plan would not be fair and reasonable is worthwhile.

i. Equity Investments Involve Risk

Richard H. McLaren points out the importance of the *Bankruptcy and Insolvency Act*\(^{18}\)’s subordination of claims of a creditor who shares in profits to the claims of all other creditors. This demonstrates Parliament’s intent to ensure a level of risk in return for equity investments.\(^{19}\) Professor McLaren notes

> Common shareholders must accept the risks of corporate failure as part of the investment bargain, which allows them to share in profit potential. Therefore, if a company is insolvent, the fact that the shareholders will receive no value under a plan does not mean that it is unfair. After all, insolvency of a corporation necessarily means liabilities exceed the value of assets, and thus there can be no value to the shareholder’s equity. Individuals holding equity without value should not impede a corporation’s reorganization.\(^{20}\)

\(^{17}\) *Algoma Steel Corp v Royal Bank* (1992), 11 CBR (3d)1 (Ont Gen Div). See also Stelco: *Sanction Order; Canadian Airlines*.

\(^{18}\) RSC, 1985, c B-3.

\(^{19}\) *Supra* note 6 at ¶ 4.7950.

\(^{20}\) *Supra* note 6 at ¶ 4.7950.
The courts have accepted a similar view. In *Nelson Financial Group Ltd., Re*[^21] while classifying the claims of preferred shareholders and determining priority, Pepall J. said the following

> [O]n the insolvency of a company, the claim of creditors have always ranked ahead of the claims of shareholders for the return of their capital. This principle is premised on the notion that shareholders are understood to be higher risk participants who have chosen to tie their investment to the fortunes of the corporation. In contrast, creditors choose a lower level of exposure, the assumption being that they will rank ahead of shareholders in an insolvency. Put differently, amongst other things, equity investors bear the risk relating to the integrity and character of the management.

If equity investors wish to share in the profits of a successful corporation, they must also share in the losses if the corporation becomes insolvent. If this were not the case, there would be opportunities available to equity investors that would lead to market inefficiencies. Moreover, creditors do not have the benefit of potential profit sharing. They have merely lent money to the corporation with an expectation of repayment at some time down the road. This inequality must warrant different treatments during a workout, otherwise unfairness to creditors would no doubt ensue.

**iii. The Phoenix Factor**

As discussed above, once the company is insolvent, the shareholders no longer possess any meaningful interest in it. Through a restructuring process, a going concern may emerge and might prove to be profitable. This does not mean that pre-existing shareholders should reap any benefit from this “phoenix” entity. In *Stelco*, several limited partnerships arose from the ashes from the CCAA restructuring. The aggregate of these partnerships should not be looked at as the same entity that entered CCAA protection, but as new concerns, free from any equity claims that pre-dated them. The court’s finding in *Stelco* suggests that once the court cancels the equity of a corporation, that corporation is no more.

Further justification is found when considering what is fair to the equity holders of the new entities. One reality that will be encountered during a restructuring under the CCAA is that a capital infusion will likely be necessary in order for the plan to be successful and for a solvent entity to emerge.\textsuperscript{22} Therefore, the issuance of new equity is usually a necessary component of any restructuring process. This involves the infusion of capital by investors who in return, take an equity position in the new entity. Why should these white knight investors be forced to share the equity in a company that they financed? This seems especially unfair when you consider that they would be sharing with previous shareholders who may have squandered the former company. It is estimated that 80% of all business failures are primarily caused by poor management.\textsuperscript{23} Shareholders were in control of the management of the company and led it down the path the insolvency, where it was unable to meet its obligations to the creditors. The shareholders should not be rewarded for their failures. Further, creditors are more likely to participate in the restructuring if they are to receive an equity position in the new company. At some time in the future, they may recoup some of what they compromised if the restructured entity is profitable.\textsuperscript{24} Applying the same principles as s.6(8) of the CCAA, it would be unfair to see pre-existing shareholders receive an equity position in the phoenix when creditors claims have not been fully paid. If there is a possibility of issuing equity in the restructured company, the new equity should be given to the creditors who were forced to compromise.

\textbf{iv. Decoupling}

Unfairness and inefficiency are also reduced with the removal of pre-existing shareholder voting privileges. A clear separation between economic interest and voting rights becomes apparent in the case of the shareholders of an insolvent company. An analogous problem has been witnessed where corporate voting rights are obtained exclusive of any economic interest in the corporation. This can be accomplished with the use of derivatives, such as equity swaps, where an investor obtains an economic interest

\begin{itemize}
  \item \textsuperscript{22} \textit{Supra} note 6 at § 4.7850.
  \item \textsuperscript{23} \textit{Supra} note 6 at § 4.8175.
  \item \textsuperscript{24} \textit{Supra} note 6 at § 4.8000.
\end{itemize}
without actually owning the shares. In these arrangements, it is possible to have a majority voting position, but actually have a negative economic interest in the corporation. Therefore, it would be in this shareholder’s best interest for the corporation to fail, and they will vote accordingly. The concept of a separation of the bundle of rights entitled to shareholders is discussed in detail and referred to as “decoupling” by Professor Henry Hu of the University of Texas Law School. As can be imagined, this issue raises many concerns of fairness and economic efficiency. Similar concerns arise if shareholders were allowed to vote on a proposed plan during a restructuring. As previously mentioned, these shareholders have nothing to lose, as their interests are eliminated under the plan, and they would receive nothing in a liquidation scenario. However, if creditors operated with the fear of having the shareholders veto the plan, they may be forced to offer the shareholders value in return for voting in a certain way.

IV. CONCLUSION

Much of the uncertainty when dealing with equity claims under the CCAA has now been resolved with the statutory amendments triggered by the case development in the area. While some may view the current treatment of shareholders in restructuring proceedings as oppressive, the reasons above should point in another direction. The courts have correctly ruled that plans which provide for the elimination of existing shares and the removal of the holders’ voting rights are fair and reasonable. The amendments to the CCAA, which codify this jurisprudence, should be lauded and viewed as a step in the right direction for insolvency law in Canada.

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