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INTERNATIONAL LAWYERS NETWORK

FOGLER RUBINOFF LLP

Bankruptcy, Insolvency & Rehabilitation Proceedings in Canada

ILN RESTRUCTURING & INSOLVENCY GROUP

KEY FACTS OF BANKRUPTCY, INSOLVENCY & REHABILITATION PROCEEDINGS UNDER CANADIAN LAW

1. Canada's Political and Legal System

Canada has a federal system of government, subject to its Constitution, which was significantly overhauled in the early 1980's, including the creation and implementation of the 1982 Canadian Charter of Rights and Freedoms. Canada places a high value on 'rule of law' concepts in Anglo-American legal traditions. It has both federal and provincial political and legal systems and courts, subject to the common law in various jurisdictions, and civil law in Quebec. The Canadian Parliament is responsible for federal laws, and various provincial legislatures enact local legislation in their jurisdictions. The Province of Quebec implements its Civil Code, largely derived from the French Napoleonic Code in origin and amended over time, in its legislature, called Assemblée nationale du Québec. There are courts with both federal and provincial jurisdiction that make rulings within their jurisdiction, resulting in a general body of common law (with civil law in Quebec), in either official language: English or French, or sometimes in both. Where necessary, the legal principle of 'paramountcy' is applied, whereby federal statutes are intended to prevail over provincial statutes when their terms and application conflict.

2. Canadian Insolvency Regime

Insolvency and bankruptcy laws in Canada are generally of the federal domain. Provincial and regional laws are used to implement and interpret issues falling within this domain. There is no single law or statute governing corporate, commercial, or institutional restructuring, bankruptcy or insolvency issues. Insolvency professionals with standing in insolvency proceedings in Canadian courts are usually either licensed lawyers or accounting professionals, with appropriate accreditation.

There are multiple applicable Canadian insolvency and restructuring statutes, listed below. The *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 (the "*BIA*") and the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 (the "*CCAA*"), collectively called the "**Acts**") comprise the "main" statutory framework for individual and corporate insolvencies, restructuring, and bankruptcies in Canada. Stays of proceedings are implemented to allow for re-organisations, restructurings, or liquidations to occur in the best interests of stakeholders and in an orderly fashion. Proceedings under the *BIA* and *CCAA* are monitored and regulated by the federally regulated Office of the Superintendent of Bankruptcy, to whom provincial Official Receivers submit their reports.

Applicable statutes in Canada:

i. The *BIA*; This is the main federal statute for personal or 'consumer' bankruptcies. It also has a broader section for both higher net-worth personal bankruptcies and larger corporate and commercial bankruptcy or restructuring opportunities. The *BIA* contains rules for both liquidations or debtor-driven restructurings and reorganisations (generally called 'proposals'), with both creditor remedies (including receiverships), and 'debtor in possession' ("**DIP**") remedies. A statutory priority waterfall for claims against the estate of an insolvent person or entity exists for secured and preferred creditors, thereby implementing rules for dealing with those priority claims in multiple scenarios. DIP proceedings under the *BIA* generally occur in situations in which the debts of the debtor are below CAD5,000,000. The "bankruptcy" provisions of the *BIA* are analogous to Chapter 7 of the U.S.A. *Bankruptcy Code* (the "**Code**"), but has many differences beyond the scope covered here. The "proposal" provisions are of the *BIA* are more analogous to Chapter 11 of the Code.

ii. *The CCAA*; This is the principal federal restructuring and recovery insolvency statute for DIP debtors. In comparison with the analogous *BIA* framework, it is generally more flexible in scope and application. The *CCAA* evolved from a largely unused and very brief statute conceived in the 1930s, but has been extensively used and adapted since that time. In the present day, it is used mainly for the restructuring of large commercial enterprises with aggregate debt owing in excess of CAD5,000,000. While analogous to Chapter 11 of the Code, the *CCAA* differs in many material respects, not the least of which are the generally increased speed and lower costs in most scenarios. The *CCAA* remains a relatively brief statute, and not all aspects of the law applicable in connection with proceedings there under have been codified. It allows for wide powers of judicial discretion, which is of utility in quickly changing fact scenarios. Cases coming within its wide scope have received a considerable display of jurisprudential flexibility and expediency in many cases, due to the lack of codified rules and procedures.

iii. The Personal Property Security Act/Civil Code in each Province (collectively, "***PPSAs***"); Each province outside Quebec has enacted statutes relating to property rights in assets and security, to partially replace a pre-existing patchwork of common law that preceded them. They also allow for the appointment of receivers both in and out of court. The *PPSAs* contain attachment, perfection, and priority rules in collateral that were initially modelled on the *Uniform Commercial Code* used in US States (collectively, "**UCC**"), but do nevertheless have significant differences. For instance, the *PPSAs* are mainly notice registry systems, and are not title based. There are also differences with UCC Article 9 procedures and accommodation for security interests in cash collateral, and other personal property.

iv. Rules of Court/Rules of Practice ("**Rules**"); These apply in all provinces other than Quebec, and have direct and indirect influences on judgements and rulings regarding enforcement and interpretations under applicable statutes. For instance, where it is found to be 'just or convenient', courts may appoint receivers for interests including secured creditors.

v. The *Winding Up and Restructuring Act* ("***WURA***"); This federal statute has been used infrequently, and is generally for the restructuring and reorganisation or liquidation of specific entities, mainly banks and insurance or trust companies. In the context of more recent financial upheaval in financial markets and financial institutions in Canada and abroad, this legislation may assume a more prominent role than has unfolded in its recent past.

vi. Business Corporation Statutes; These include multiple statutes in both the federal and provincial domains, such as the *Canada Business Corporations Act* ("***CBCA***") and the various provincial counterparts. These are significant because they allow courts to authorise fundamental changes in corporate structure in distressed scenarios. They contribute to balance sheet refreshments through such arrangements where debt can be converted to equity including through implementation of distress preferred share arrangements as may be approved in Canadian insolvency proceedings. These statutes may also be used to effect liquidations in certain circumstances.

3. The Acts: Basics

BIA

Applications for bankruptcy orders may be filed by the debtor, or by his/her/its creditors. When filed by creditors, there can be proceedings contesting the filing, to be heard by the bankruptcy courts. Otherwise, liquidations ensue once the trustee in bankruptcy is appointed under a bankruptcy order and that person is usually an accredited accounting professional. That trustee in bankruptcy acts in the estate, effectively on behalf of the general body of creditors. Secured creditors holding perfected security interests take outside of the bankruptcy estate to the extent of the value of their collateral held, and will file claims in the estate for unpaid residual amounts of debt not recovered from realization of their specific collateral held.

To avoid bankruptcy, proposals may be filed by debtors under notices of intention ("**NOI**"). These are not initially bankruptcy filings. An accountant is engaged as "Proposal Trustee" to oversee and review the affairs of the debtor, and to report to the court in all proceedings. On filing the NOI, the time "starts ticking". Initially, a 30-day stay is granted, and can be extended up to a maximum of six months by the court, to enable the debtor to file a plan. Time is granted to compose a plan, which is distributed to creditors for a vote. For the proposal to be approved, a 'double majority' vote that occurs with approved creditors will be necessary, in which a majority of both creditors by number and total of outstanding debt thresholds must be met to pass the vote. If the creditors approve the plan, court approval is thereafter required. If timelines are not met, or a plan is neither presented nor approved by creditor vote and court approval, then there is an automatic deemed bankruptcy. At that point, the proposal trustee becomes the trustee in bankruptcy, and liquidation ensues.

All asset bankruptcy estates are subject to a 5% levy, payable to the Superintendent in Bankruptcy.

CCAA

Qualified applicants under the *CCAA* are usually applicants being corporate entities who are insolvent, or who have committed an act of bankruptcy under the *BIA*. Total claims against that debtor must exceed CAD5,000,000 before that debtor may commence a *CCAA* filing. Proceedings are initiated by court applications. Filings for 'first day orders' are done by application of the debtor to the applicable court. There may be an initial order implementing a statutory stay of proceedings, but it is granted for a very short period of time and on restricted terms and conditions (colloquially sometimes referred to as the 'skinny order'), in effect for no more than ten days. The applicants must return to court within that time period with another application for the full form of court orders giving broader protections to the Applicant.

Monitors are appointed upon initial orders being granted and are deemed to be officers of the Court, and as such are the "eyes and ears" of the Court in the proceedings. The debtor's auditors are excluded from being appointed as Monitor. Monitors are ideally positioned to act in the 'best interests of the general body of creditors'. Their views and recommendations are submitted to the courts in formal reports, which are generally given a high degree of factual and professional deference. Once appointed to oversee the *CCAA* estate in the first day orders, Monitors coordinate multiple roles. Those include the review of financial information, filing of statutory reports, review of debtor forecasts and plans, implementation of a sale process, and assisting in the drafting of a Plan of Compromise or Arrangement (**"Plans"**). Plans, once approved by creditors in a double majority vote, must also be sanctioned by a Canadian court.

Plans can include sale processes, such as 'stalking horse' bidding procedures for all or part of the business, assets and operations of the debtor, or a broader group of companies and partnership entities connected to the debtor. They may also include full or partial liquidations of their assets, termination of contracts, key employee retention plans, settlement of debts and charges amounting to a balance sheet restructuring. Monitors interact with officers, directors, and management of the debtor and their counsel. They are also responsible to conducting all statutory proceedings, including any votes of creditors or other stakeholders, outside of the court proceedings.

Assets disposed of in *CCAA* proceedings are not subject to any bankruptcy levies.

Stays of Proceedings

Under the *BIA*, statutory stays of proceedings are initiated on issuance and filing an order for bankruptcy, or upon filing a NOI. Under the *CCAA*, statutory stays are initiated by the courts in first day orders, and continue under the directions of the court. Stays of proceedings can be implemented for groups of companies domestically, within the ambit of the Canadian courts. For cross border groups, the continuing cooperation of foreign courts is required, with varying results from case to case.

Cross Border Proceedings

Coordination of cross-border proceedings with foreign courts is encouraged and implemented on a regular basis. Canada adopted the UNCITRAL model law on cross border insolvency in 1997, with changes specific to Canada at and after that time. This is incorporated into Canadian law under Part IV of the *CCAA* and Part XIII of the *BIA*, for both recognition of foreign proceedings in Canada, and for recognition of the orders of Canadian courts in foreign proceedings. Canadian courts can exercise jurisdiction over non-Canadian entities and assets if the 'centre of main interest', known as "COMI", is in Canada. These always involve questions of fact, and can be hotly contested at the outset of proceedings. *In the Matter of Voyager Digital* recently saw the Ontario Superior Court provide renewed guidance on the determination of COMI in the context of a public company. Cross border cooperation of foreign courts with Canadian courts has occurred in multiple cases, including under Chapter 15 proceedings under the Code.

Officers and Directors

Generally, directors and officers of corporations have statutory duties to act honestly and in good faith with a view to the best interests of the corporation (including under the *CBCA*). Directors of an entity entering proceedings under the Acts must continue to generally act in the general best interests of that debtor. They must exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances. Officers have similar duties including remittance obligations to government authorities. While there are duties to 'stakeholders', such as government entities, creditors and employees, there is no specific duty on directors or officers to look after the interests of shareholders. Unlike other jurisdictions, such as Australia, Germany, and France, there are no 'trading while insolvent' liabilities or exposures while the debtor is undergoing a formal restructuring while also operating its business. Remedies sought for breach of such duties, in the absence of fraud, are generally fact-based proceedings, within these general principles.

Additionally, directors should take note that under certain statutory circumstances, directors may be found personally liable for unpaid employee wages and holiday pay, and source deductions for employee income taxes, employment insurance and government pension plan contributions.

4. The Acts: Changing Rules and Features and Updates

In recent years, the Acts were amended to achieve better accountability and transparency in Canadian insolvency proceedings.

Disclosure of Economic Interests

The *CCAA* was amended to allow interested persons to apply for a court order requiring a person to disclose any "economic interest" in the debtor company. An "economic interest" includes a claim, eligible financial contract, an option, a mortgage, charge, lien, other security interest, the consideration paid for any right or interest, or any other prescribed right or interest. The court must consider whether the information sought would enhance the prospects of a compromise or arrangement for the debtor company and whether any interested person would be materially prejudiced by the disclosure.

The purpose of this may be aimed at leveling the playing field in the administration of estates. Possible scenarios where disclosure might be particularly important are (i) where claims are traded at discount values to purchase blocking votes or (ii) where related parties or parties with undisclosed collateral interests bid on assets of the insolvent estate.

Pension Funding and Obligations

To protect the interests of retirees and pensioners, the Acts were amended to require that funds earmarked for registered disability savings plans be added to funds in RRIF plans and RRSPs so that they are exempt from seizure under the *BIA*. The *CBCA* was simultaneously amended to require that directors take into account the financial interests of retirees and pensioners in board deliberations of *CBCA* companies on the eve of insolvency.

Further, in 2023 legislation was passed expanding the super-priority positions afforded to defined benefit pension plans in the course of an employers' insolvency. Importantly, a transition timeframe has been built into this expansion of the super-priority (four years) for defined benefit plans. This will provide existing lenders and employers with some ability to pivot around the new reality but not much and new employers will not have the same transition period.

Director and Officer Compensation Clawbacks

The amendments expose directors to more scrutiny on the eve of insolvency. The courts may "look back" into payments (including termination pay, severance pay, incentive and other benefits) made to directors, officers, and other managing personnel in the year preceding the initial bankruptcy event. If the payments were made when the corporation was insolvent or rendered the corporation insolvent, exceeded the fair market value of the consideration received by the corporation, or were outside the ordinary course of business, the court may issue judgments against the directors personally, as may be appropriate.

Third Party Releases

Court-ordered releases within *CCAA* Plans are common in the context of sanction orders. In many cases, it is management and board members who benefit. Directors and officers will usually insist on these in return for avoiding mass resignations during the reorganisation of the insolvent entity.

Procedural Changes

Stays of proceedings will be granted in *CCAA* proceedings if "reasonably necessary" for the continued operations of the debtor companies. The initial stay period was reduced from 30 days to 10 days. As well, other initial relief in first day orders will only be granted if "reasonably necessary". These amendments will help ensure that orders granted at the commencement of insolvency do not over-reach, and are fair to other creditor interests. Certain relief like new funding (DIP financing orders) and pre-baked solicitation proceedings for the sale of assets, which may prejudice stakeholders who had no notice of insolvency proceedings, may now be challenged earlier.

Statutory Duty of Good Faith

In *Bhasin v Hrynew*, the Supreme Court recognized a general duty of honest performance in contractual dealings which has been broadly applied. Canadian courts must now consider good faith and disclosure of economic interests to enhance their jurisdiction in restructuring matters. Parliamentary debates preceding the amendments suggest that they were intended to protect the public from the effects of high-profile corporate bankruptcies like *Nortel* and *Sears* where many Canadian employees lost their pensions. A statutory duty to act in good faith will now apply to all participants in Canadian insolvency proceedings. Although debtors previously had a duty to act in good faith, the statutory duty now applies to all parties. This amendment is consistent with developments in the common law. In *Century Services Inc v Canada (Attorney General)* the Supreme Court of Canada stated that "the requirements of appropriateness, good faith and due diligence are baseline considerations that a court should always bear in mind when exercising CCAA authority". A statutory duty of good faith is also consistent with British and American insolvency statutes and will therefore be useful in cross-border proceedings.

No Equitable Subordination in Canada, so Far

The doctrine of equitable subordination is an American legal doctrine that allows a court to subordinate a creditor's claim and ranking in an insolvency proceeding where that creditor has acted badly, in the determination of the court. Canadian courts have resisted its application over an extended period of time in numerous insolvency proceedings. However, it remains as an attractive equitable doctrine to be applied as a potential course of redress. Recent statutory implementation of the duty of good faith in Canada appears to have provided another reason to not apply this doctrine in Canadian proceedings to address the bad behavior of certain creditors. However, this doctrine has not yet been definitively shut off by the highest Canadian courts either, to date.

Reverse Vesting Orders

There have been recent developments in the case law regarding the use of reverse vesting orders (**"RVO"**) as a means of providing court approval to certain transactions to be effected in the context of an insolvency proceeding. Through the use of a reverse vesting order, the court may transfer liabilities or undesired assets "out of" the debtor company and "into" a new company or other available existing subsidiary entity. The impact is to "cleanse" the debtor problematic assets or liabilities so as to effect a new state of affairs in assistance of the restructuring. This is a "reverse" to the approach of the traditional approval and vesting order where in the valuable assets are transferred to the court approved buyer with secured interests being vested out.

Of particular in note, in *Harte Gold Corp. Re*, the Ontario Superior Court provided some important new guidance on what questions the court should investigate when asked to approve a RVO: (1) Why is the RVO necessary in this case? (2) Does the RVO structure produce an economic result at least as favourable as any other viable alternative? (3) Is any stakeholder worse off under the RVO structure than they would have been under any other viable alternative? (4) Does the consideration being paid for the debtor's business reflect the importance and value of the licenses and permits (or other intangible assets) being preserved under the RVO structure? While this test has been set out, the body of law firmly establishing the conditions under which the court might refuse a RVO is in its relative infancy and still developing.

Environmental Obligations and Priorities

In 2019 the Supreme Court of Canada released its decision in the case of *Orphan Well Association v. Grant Thornton Ltd.*, which held that certain environmental remediation obligations of an insolvent entity can and should be prioritized over and above the rights of secured creditors in the context of a closed oil and gas operation. More recently, the court in the Province of Alberta has issued several decisions that have potentially expanded the context in which such a super-priority might be found to apply. At the time of this update, however, there are active appeals in this area and so further clarity on the law in this area may be expected in the near future.