DAVIES

Issue 9

# Insolvency Now

## Business Insolvency on the Rise in Canada: Understanding the Role of AI

# Contents

# Introduction

The priority of governments and financial authorities around the world in 2023, including in Canada, has been to reduce inflation while monitoring and addressing financial sector risks. The Bank of Canada estimates that inflation will likely remain near 3% through 2024, given strong household spending levels supported by tight labour markets, population growth and high levels of accumulated household savings.

In this issue of *Davies Insolvency Now*, we examine Q1 and Q2 of 2023 insolvency data to compare how different economic sectors have responded to uncertain global and Canadian financial conditions. For instance, the retail trade sector was particularly affected this year, reporting seven restructurings under the *Companies' Creditors Arrangement Act* (CCAA) in the first half of 2023 compared with one restructuring in the first half of 2022.

Turning from big picture insolvency data to the development of artificial intelligence (AI) technologies, we discuss how AI-powered programs are becoming increasingly important practical tools for insolvency practitioners. AI can be a game changer for data capture, process automation, error detection and real-time document processing. For lawyers, creditors and stakeholders as well as regulators and courts that contemplate adopting AI tools, there is significant potential to improve work efficiency and quality. However, the implementation and reliance on these technologies is not without risks.

Davies Insolvency Now *is a publication authored by Natasha MacParland, Robin B. Schwill and Stephanie Ben-Ishai that analyzes key trends and developments in the insolvency and restructuring community.*

# Insolvency Data for First Half of 2023: Highlights

The Office of the Superintendent of Bankruptcy reported a total of 2,160 business bankruptcies and proposals during Q1 and Q2 of 2023. This represents the highest number of business insolvencies reported in the first half of a calendar year since 2019. Notably, it is a 34.7% year-over-year increase from 2022 levels and a 78.4% increase from the lowest reporting year (2021) in the last five years (see Figures 1, 2 and 3). Although this overall increase is dramatic, the data should be viewed in the context of historically low levels of insolvency filings throughout the pandemic. As we see certain sectors and geographies driving the bulk of business insolvency increases, this trend lends support to claims that the Canadian economy is observing a rolling recession.

**Figure 1: Total Business Insolvencies in Canada**

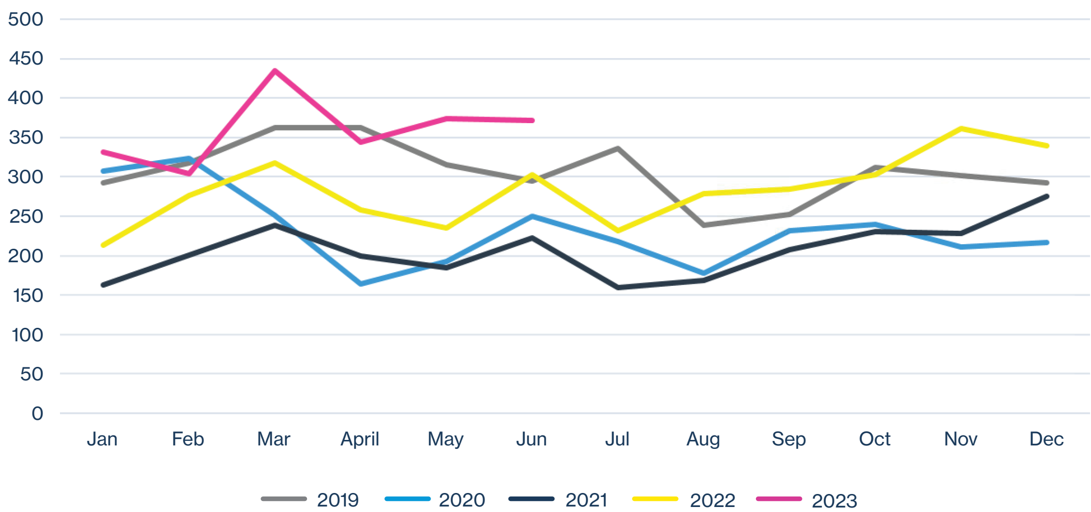


**Figure 2:** **Business Bankruptcies in Canada**

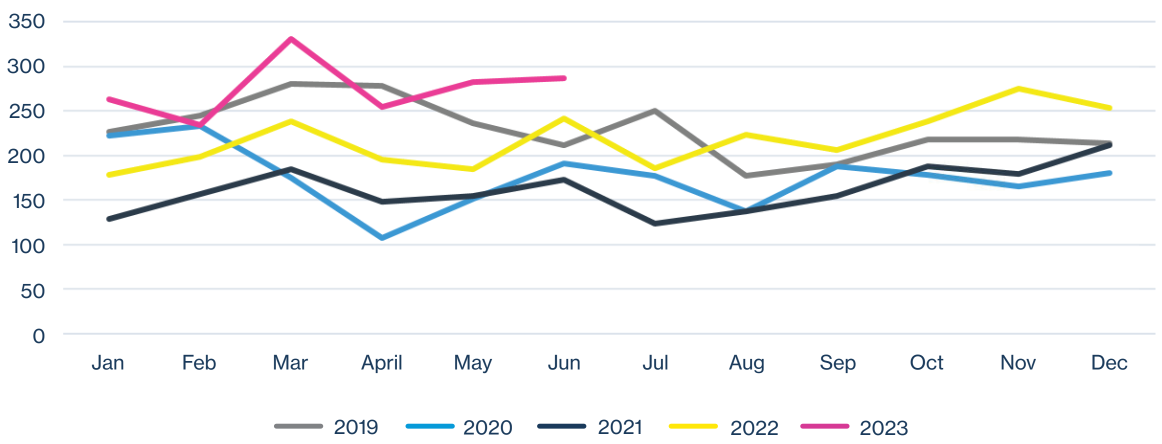
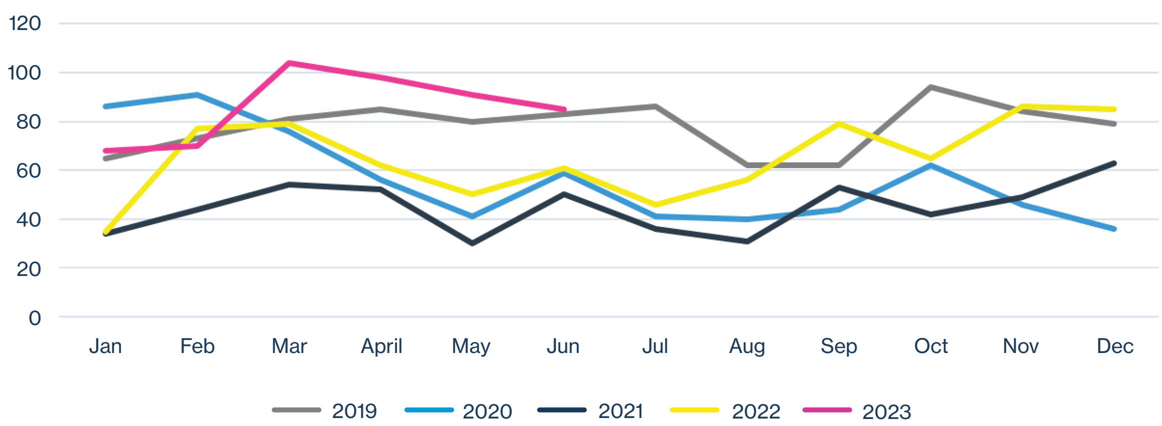


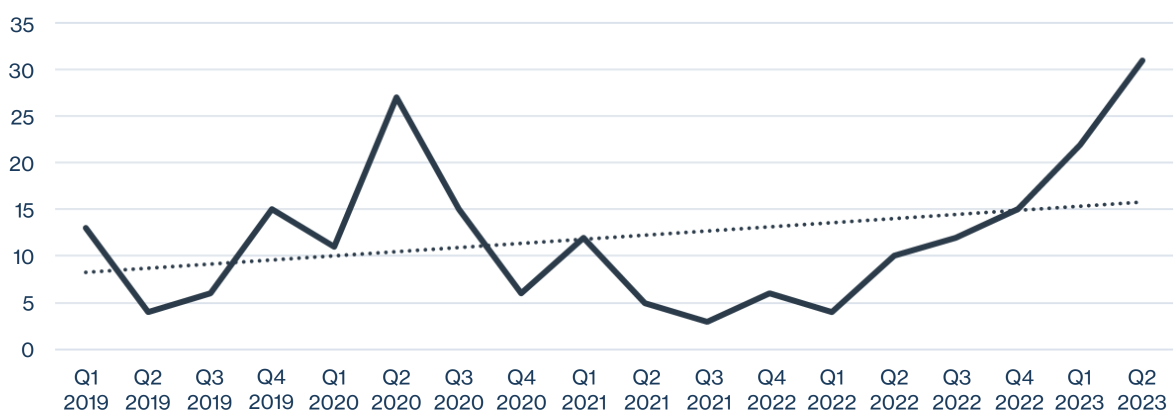

**Figure 3:** **Business Proposals in Canada**



Both business bankruptcies and proposals increased sharply in March 2023 (see Figures 2 and 3), a month that coincided with the winding up or distress of Silicon Valley Bank (SVB), Signature Bank of New York and First Republic Bank. The global banking sector also saw the merger between Credit Suisse Group and UBS Group, which highlighted the concerns of authorities around the world regarding liquidity and the implications of continued interest rate hikes.

By Q2 2023, the number of CCAA proceedings in Canada had reached 31, surpassing the historical high point of CCAA activity of 27 proceedings in Q2 2020 (see Figure 4). It remains to be seen whether the increased bankruptcy filings and use of bankruptcy procedures will grow alongside the use of CCAA procedures.

**Figure 4: CCAA Proceedings in Canada**



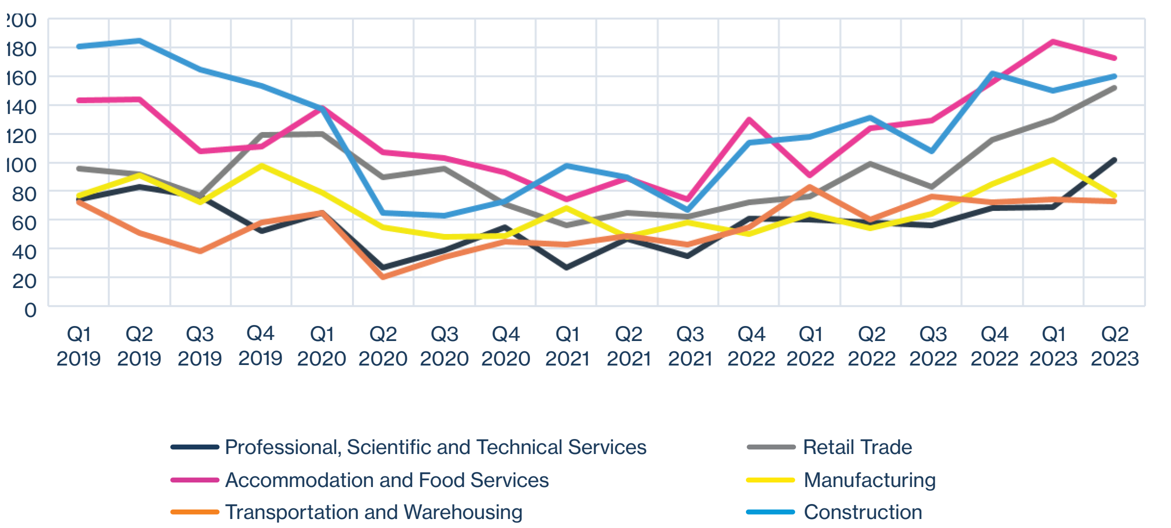

## SECTOR-BY-SECTOR OBSERVATIONS

Four sectors registered the biggest increase in the number of insolvencies in Q1 and Q2 of 2023: retail trade, covering store retailers, those providing after-sales repair and installation services and those who distribute through broadcasting and door-to-door solicitation, which includes businesses such as construction; accommodation and food services; and professional, scientific and technical services, such as legal, accounting, tax, payroll, architectural, scientific research, public relations and technical consulting service providers (see Figure 5). Accommodation and food services seems to have rebounded in Q2 2023 from its peak filing volumes in Q1, while the number of insolvency filings of the other three sectors is trending upward. The retail trade sector underwent 282 insolvency filings in the first half of 2023, indicating a 61% increase over the 175 filings in the first half of 2022. Within these 282 filings, 226 (80.1%) were bankruptcies and 56 (19.9%) were business proposals. We therefore observe a slight decrease in the proportion of bankruptcy filings, from 84.4% of retail trade sector filings through Q3 and Q4 of 2022 to the current 80.1% level.

The accommodation and food services sector underwent a growing number of filings during 2022. This upward trend continued through the first half of 2023. There were 357 filings in Q1 and Q2 2023 compared with 163 filings and 215 filings for the first half of 2021 and 2022, respectively. Businesses in this sector were likely affected by rising costs of materials and personnel. Discretionary spending on certain recreational services was also at risk, with signs of economic downturn, which could have contributed to increased insolvency filings.

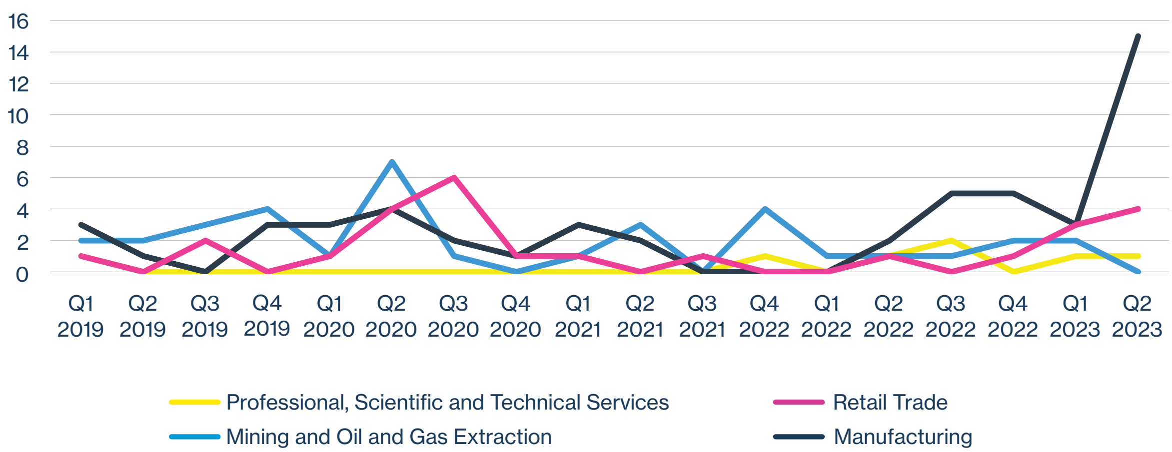
Another notable sector that we highlight for the first time is the professional, scientific and technical services sector. From 2019 through 2022, this sector averaged 18.4 insolvency filings per month. Since January 2023, the monthly average jumped to 28.5 filings per month and peaked at 43 filings in April 2023. Thus, the data suggest volatile lack of demand for knowledge-based work so far in 2023.

**Figure 5: Total Insolvencies in the Most Affected Sectors, 2019–2023**



In the manufacturing sector, insolvency filings since Q4 2021 peaked in Q1 2023. Q2 2023 saw a 24.5% quarter-over-quarter decrease in filings, but high levels of CCAA activity in its place. As Figure 6 shows, 15 CCAA proceedings were filed in the manufacturing sector, making up 48.4% of all CCAA proceedings in Q2 2023. That number is almost as many CCAA proceedings in the manufacturing sector in 2021 and 2022 – that is, a total of 17 filings over the two years.

**Figure 6: CCAA Proceedings in Select Sectors, 2019–2023**




## REGIONAL OBSERVATIONS

In Ontario, 103 receiverships with a total declared asset value of about $277.5 million took place in Q1 and Q2 of 2023. This level of receivership value is far higher than in 2022, when there were 108 receiverships with a total declared asset value of $77.7 million all year. The most activity took place during May 2023, when 27 receiverships were reported, with over $199 million in declared assets from court-appointed receiverships. Ontario CCAA activity maintained an above-average number of proceedings in the first half of 2023: 14 CCAA proceedings so far in 2023, compared with 13 proceedings during all of 2022.

Québec has also seen increased receivership activity since the start of 2023: 25 receiverships totalled about $10.4 million in declared assets. This activity is significant because Québec had just nine receiverships totalling

$4.7 million in declared assets through all of 2022, which indicated an average of around $522,000 in declared assets per receivership. In Q1 and Q2 2023, there were more receivership orders, but with a lower average asset value of $416,000 per receivership. Québec CCAA proceedings are currently stable at between two to three filings per quarter since Q3 of 2022.

British Columbia reported the highest value of assets in receivership so far in 2023, at about $341 million. This total was largely due to activity in February 2023, when two court-appointed receiverships reported $238.6 million in declared assets. This figure is a sharp increase from last year, when $14.8 million in declared assets were in receivership throughout 2022. As expected, the number of business insolvencies showed an increase of 60.3% year over year.

On the other hand, Alberta receivership activity has declined to very low levels since being the outlier of high activity in December 2022. Q1 and Q2 2023 data showed 16 receiverships valuing about $19.9 million, which is lower than any six-month period since January 2019. At the same time, Alberta reported four CCAA proceedings in the first half of 2023, whereas the province reported a total of four and two CCAA proceedings in 2021 and 2022, respectively.

## AI Tools in Insolvency

With the evidence of a rapid increase in insolvency activity as we approach 2024, Canadian insolvency practitioners, regulators and stakeholders, like those in other jurisdictions, are increasingly thinking about the most efficient yet equitable methods for resolving proceedings.

As early as 2019, the 2019 EU Restructuring Directive suggested that the acceleration of the use of AI in insolvency practice is underway. This was an expected step launched by the digitization of insolvency procedures to help reduce their length and increase their efficiency, with the goal of lowering the costs of restructuring and increasing recovery rates for creditors. While it is true that AI has the potential to innovate and disrupt insolvency practice, it is important to be aware of the views of Geoffrey Hinton, the computer scientist known as the Godfather of Artificial Intelligence. His views recently went viral in the tech world when he quit his job at Google, citing his fears about the dangers of AI technology. ChatGPT itself has much to say about safety, transparency, reliability, monitoring, etc., when asked about how AI should be best regulated. There are also concerns over protecting data security and privacy, as well as reducing biases in algorithm design. Even as we grapple with these questions, there is no doubt that insolvency practice will likely see AI's effect more significantly than other areas of law, given its close ties to accounting and finance, which both already rely heavily on AI.

Insolvency and restructuring work often involve engaging with large sets of company documents, offering numerous opportunities for AI to be applied to data capture, classification and process automation. At Davies, we are seriously thinking and making careful decisions about how we use AI. And we are watching closely to see how AI will affect and transform insolvency law and practice in Canada.

The following are some of the ways we expect AI to play a role in corporate insolvency practice in the future.

### E-DISCOVERY

We have already seen how e-discovery has transformed litigation practice more generally by using predictive coding to classify electronic documents. Increasingly, AI is making it possible to reduce the human element of the review process. This is true for insolvency litigation as well. However, given the high level of discretion and sophisticated expertise required in this area, counsel must still provide the specific advice that debtors, creditors and stakeholders need. Decision-making and advice in this context can certainly be improved through the use of e-discovery technology that identifies patterns and concepts, and offers visualization tools that support litigation strategies.

Insolvency lawyers must make decisions about the level of technology versus human element to deploy, by carefully analyzing the potential outcome of the claim or proceeding. As insolvency practice is often cross-border and increasingly global, the skilled deployment of various AI tools will become more important and can no longer be handled by individual lawyers alone.

### PREDICTING CREDIT DEFAULT

Increasingly replacing traditional statistical techniques, AI has been used in financial decision-making to predict credit default events. Much has been written about the mixed success of the tools and techniques for predicting the financial failure of corporations. The methods have involved using a set of historical data on successful and failed companies. However, because bankruptcy is a rare occurrence, to this point machine-learning has had insufficient information to understand the sets of attributes that can lead to a future bankruptcy. Attempts are currently underway to overcome this challenge by combining the most successful individual algorithms to achieve a higher degree of forecasting accuracy. At the same time, given the discretionary elements involved, it is unlikely that AI will be able to determine the decisions that companies will make on timing of filing and the appropriate procedure on the basis of a complete analysis of the current state of the law.

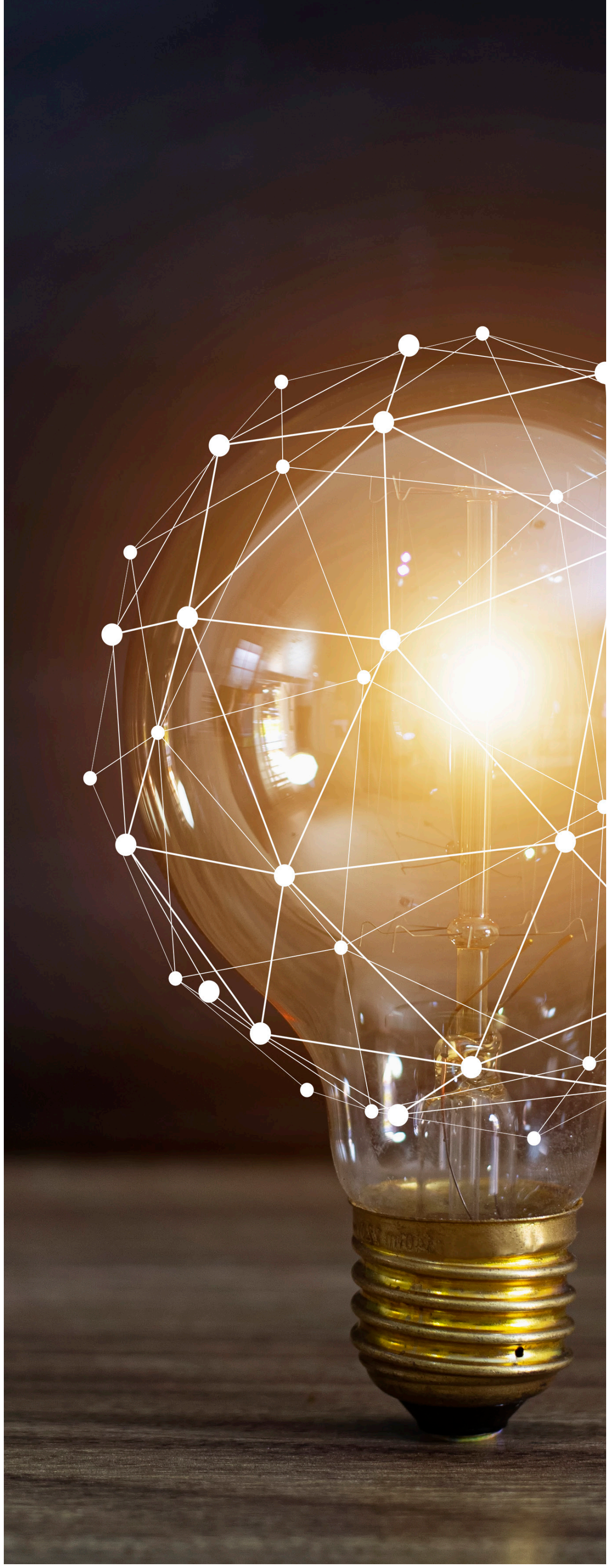
### ROSS: INSOLVENCY SUPPORT LAWYER

Some of our readers may be surprised to learn that ROSS Intelligence, the first AI research tool used by a law firm, was in fact trained with specific insolvency expertise. ROSS expanded to cover other areas and was similar to earlier research tools such as Westlaw, but with less required of the lawyer to ask questions. That is, lawyers would type in questions using natural language to find relevant up-to-date case law or to extract quotes or precedents in support of an argument. However, ROSS Intelligence ceased operations in 2020 due to ongoing litigation with Thomson Reuters. As any lawyer who has used legal research tools knows, no technology has to this point been able to replace the strategic thinking that goes into negotiating a complex restructuring or sale process, let alone ask the questions that the lawyer should be asking tools like ROSS. Important human dynamics are involved behind the commercial decisions that are made, and a deep understanding of more than the law on the books is necessary for any transaction. At the same time, lawyers are now expected to automate, to the extent possible, parts of legal research and the analysis process; they are also expected to make informed decisions about which parts can be automated.

AI will also likely play a role in how information provided by the debtor is verified, researched and investigated by creditors. New tools will develop to assist with questions of disclosure and valuation of assets, among other impacts on the bankruptcy process. Notably, AI can be used to look deeper than credit scores and, instead, establish companies' ability to repay by looking at data trends. For example, Mitsubishi UFJ Financial Group (MUFG), one of the world's largest lenders, kicked off a digital transformation initiative in 2019 that centres on the use of AI and machine learning. Through this initiative, MUFG integrated an AI-based credit scoring system into its "on-line data lending" model, which evaluates the account activities of corporations in real time. As a result, MUFG is able to make faster decisions and meet client's immediate needs – a competitive advantage in this industry. Further, the Japanese company has revealed that its AI credit assessment tool for housing loans has resulted in a 50% decrease in the data that officers need to input. As a result, MUFG has demonstrated how AI can help creditors throughout the lending life cycle by streamlining processes, ensuring that they can spend more time on higher value-added activities.

## A TOOL FOR STAKEHOLDERS

Third parties and stakeholders can use AI to advance their rights and interests in insolvency proceedings in ways that they previously could not. For instance, AI tools can be used as a way to increase third parties' ability to organize



actions. The union United for Respect developed an AI-enabled chatbot, WorkIt, which allowed its workforce of more than one million people to ask questions about their rights. In insolvency proceedings, AI can be leveraged similarly to get stakeholders organized and informed on an ongoing basis.

Further, AI technologies can help improve access to justice for these groups by facilitating access to legal knowledge. While AI cannot replace lawyers and does not remove the need for nuanced legal advice, AI tools can help explain legal jargon and processes in easy-to-understand terms by using natural language processing capabilities. Generative AI can even offer information that can serve as a starting point for stakeholders in their own legal research. In other words, AI can serve as a source of power to those who do not have legal training by serving as a knowledge resource.

### A TOOL FOR REGULATORS

The regulators involved – for example, the Office of the Superintendent of Bankruptcy – are also piloting ways to harness the power of AI to do their job faster and to intervene on matters more frequently. In particular, it is likely that AI-enhanced technology will enable the regulators to more quickly and effectively address instances of fraud. The past couple of years have seen instances of technology being used for nefarious purposes in insolvency and corporate matters, aiding in payment fraud, identify theft and even phishing attacks. Regulators can use AI to combat this evolution of crime. For instance, AI technology allows organizations to analyze large amounts of data for patterns and outliers. Using these technologies, regulators can combat novel types of crime as they arise.

Recently, regulators such as the Office of the Superintendent of Financial Institutions (OSFI) have been considering ways to respond more quickly to contain rumours that may cause a run on deposits without the need to physically attend at the bank in a post-SVB world. In the case of SVB, on Wednesday, March 8, 2023, it was a billion-dollar bank that had just announced plans to raise more capital. By the following Friday, it was insolvent. Within just two days, customers were able to withdraw US $42 billion in deposits online – arguably fuelled by social media influencing the psychological behaviours of customers. In this digital era, regulators may be able to use tools like AI to help identify and counteract the online rumour mill to protect creditors and the stability of the banking system.

### THE COURTS

Much has been written outside the insolvency context about the use of ChatGPT to draft legal materials, such as a factum. Law firms have developed their own policies and procedures for the use of ChatGPT. Interestingly, the U.S Bankruptcy Court of Northern District of Texas recently issued an order related to the use of AI-generated filings.

In Re: Pleadings Using Generative Artificial Intelligence, Gen. Order No. 2023-03, Chief Judge Stacey G. C. Jernigan held:

> If any portion of a pleading or other paper filed on the Court's docket has been drafted utilizing generative artificial intelligence, including but not limited to ChatGPT, Harvey.AI, or Google Bard, the Court requires that all attorneys and pro se litigants filing such pleadings or other papers verify that any language that was generated was checked for accuracy, using print reporters, traditional legal databases, or other reliable means. Artificial intelligence systems hold no allegiance to any client, the rule of law, or the laws and Constitution of the United States and are likewise not factually or legally trustworthy sources without human verification. Failure to heed these instructions may subject attorneys or pro se litigants to sanctions pursuant to Federal Rule of Bankruptcy Procedure 9011.

We have not seen such an explicit order in the Canadian insolvency context to this point; however, courts have begun to issue practice directions and other policies relating to the use of AI. On the heels of a New York case in which lawyers submitted fictitious research generated by ChatGPT in their claim, some Canadian courts have expressed their own thoughts on the use of AI. First, the Court of King's Bench of Manitoba released a practice direction regarding the Use of Artificial Intelligence in Court Submissions. In the direction, Chief Justice Joyal stated that when AI has been used in the preparation of materials filed with the court, the materials must indicate how it was used. The judge affirmed that there are legitimate concerns about AI's reliability and accuracy. Shortly after, the Yukon Supreme Court issued a similar practice direction. While the directions released by Canadian courts do little more than double-down on the existing provincial rules of professional conduct, they should be seen as warnings to the legal community.

The commonality across all jurisdictions is that courts are recognizing AI will be used in proceedings in the future but are attempting to grapple with the policy concerns regarding its dependability. Judges are making clear that AI is still in its infancy, and the human component of law cannot be completely erased – at least not without disclosing this fact to the courts.

## ALTERNATIVE DISPUTE RESOLUTION PROCESSES

In Insolvency Now Issue 5, we outlined the increasingly significant role that alternative dispute resolution (ADR) – in the form of mediation and arbitration – has been playing in Canadian bankruptcy and restructuring cases. In other areas of law – for example the British Columbia Civil Resolution Tribunal – we have seen the growth of online dispute resolution (ODR). Technological innovations enabling online claim diagnosis, negotiation and case management – all contribute to the popularity of ODR. AI tools in this space allow less sophisticated claimants to strategize their case or pursue remedies in cost-efficient ways as well as improve access to justice for claimants in remote areas or with limited resources. If adequate safeguards to protect privacy and non-biased decision-making as well as increased information accuracy can be built, there is great potential to use ODR for claims resolution in the insolvency context.

Recently, FTX abruptly halted the sale of one of its most sought after assets – its stake in the AI startup Anthropic – demonstrating again how the AI boom is in full swing. At the time of the bankruptcy, FTX held US$500 million worth of Anthropic stock, but this has increased significantly as it reported a valuation of US$4.6 billion and raised US$450 million in its latest funding round in May 2023. As illustrated, from a business perspective, the AI boom is quickly accelerating globally. According to Stanford University's annual artificial intelligence report, the AI industry has far surpassed academia in building machine-learning models, and the demand for AI-related professional skills has grown in almost all industrial sectors.

At the same time, policy-makers are racing to keep on top of these changes in the economic sphere. Mentions of AI in global legislative proceedings have increased almost 6.5 times since 2016, and 37 bills containing the phrase "artificial intelligence" were passed into law across 127 countries in 2023. Although the future remains uncertain, it is clear that policy-makers will continue to monitor how AI is used in business and legal realms, including in insolvency proceedings.

We believe that clients will and should insist on working with insolvency professionals who are committed to effectively and responsibly using AI to shift how they practise while also using their expertise to strategically produce significant opportunities and advantages for their clients. Davies has been both an early and a cautious adopter of new technology, at all times drawing on our deep knowledge of the policy and empirical considerations in the insolvency context.

# Conclusion

Certain sectors will face pressure and contraction while other industries have opportunities to expand in a rolling recession. The effects of the series of interest rate increases over the past year will continue to work through the economy in 2023, varying in timing and impact across sectors, and eventually slowing future growth.

We continue to monitor insolvency filing trends across Canada to present relevant insights. As more experimental uses of AI technologies are tested by different stakeholders, we will monitor and stay fully engaged with potential new applications of AI tools in the context of insolvency practice, as well as how different regulators and adjudicators respond to such technological developments.

# Key Contacts

Across novel sectors, Davies has deep expertise in applying our data-driven approach to provide the most appropriate tools for recovery and resolution. Whether providing an early-stage overview or advising on a range of remedial options, we work with you to navigate your unique circumstances and reach your business goals. Please contact any of the individuals listed below or visit our website at www.dwpv.com.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