INSOLVENCY & BANKRUPTCY ISSUES FOR INFORMATION TECHNOLOGY

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I. Introduction

This paper attempts to provide a modest overview of the Canadian insolvency regime with an emphasis on the issues that can arise in a liquidation or reorganization of an information technology business. Not surprisingly, insolvency laws do not treat insolvent information technology companies any differently than any other insolvent companies. Accordingly, the fact that the property of information technology companies consists, to a large extent, of information, contracts and intangible property presents unique challenges in an insolvency because the current legislation (and relevant jurisprudence) does not have extensive experience dealing with these types of assets.

This paper looks at the issues that most often arise in an insolvency where the debtor's assets consist primarily of information, contracts, and intangible property. Unfortunately, the reader will find problems throughout the paper, but very few solutions either in the legislation or the case law. The reason for this is, simply put, that our insolvency laws were developed in an era of "bricks and mortar" businesses. Consequently, they are not designed to deal with the realities of technology-based businesses where, more often than not, the insolvent company's assets consist primarily of intellectual and intangible property rather than buildings and equipment.

II. The Framework

The Canadian insolvency regime is centred around two pieces of federal legislation: the *Bankruptcy and Insolvency Act*[1] and the *Companies' Creditors Arrangement Act*[2]. The BIA is a comprehensive statute that provides for both the liquidation, through bankruptcy, and the reorganization of insolvent debtors. Unfortunately, the statute dates from the late 1940's and, while it has been amended on a number of occasions, it still has major gaps in how it deals with contracts and intangible property in the context of both liquidations and reorganizations.

The CCAA stands in stark contrast to the BIA. Originally enacted in the 1930's, it provides only for the reorganization of larger, more complex insolvent businesses. Rather than providing detailed substantive and procedural provisions to govern all aspects of the reorganization like the BIA, the CCAA provides a general framework and then leaves it to the debtor to work out the details of the process under court supervision. Much of the law under the CCAA developed by way of judicial interpretation.

In addition to the liquidation and restructuring regimes of the BIA and the CCAA, this paper deals briefly with court-appointed receivers and interim receivers. Both are appointed by the court in insolvencies and play an important role in liquidations and reorganizations where they are used to effect asset sales.

The aim of liquidation is to maximize the value of the insolvent company's assets. This generally involves selling the insolvent company's assets to the party or parties willing to pay the highest price. In the case of an information technology business, this can involve selling intellectual property free and clear of contractual rights, such as licenses, or selling hard assets, such as computers, together with contractual rights such as licenses. The aim of restructuring, on the other hand, is to preserve the going concern value of a business. Although restructuring may involve selling assets, it will usually also involve terminating or disclaiming unprofitable contracts, renegotiating contracts (often under

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1 R.S.C. 1985, c. B-3, as amended (the "BIA").

2 R.S.C. 1985, c. C-36, as amended (the "CCAA").

threat of termination), closing down divisions, terminating employees, etc. The objective is to "fix" the business that existed prior to the commencement of the formal insolvency procedure, thereby creating a new business that can viably go forward for the benefit of stakeholders.

It is important to note that while this paper makes a clear distinction between the liquidation of insolvent companies, on the one hand, and their reorganization on the other, in modern insolvency practice the line between a "reorganization" and a "liquidation" is often blurred. Many liquidations involve the sale of all the assets of an insolvent company to a new company which continues to carry on the insolvent company's business and many attempted reorganizations ultimately result in the orderly liquidation of the insolvent company's assets.

III. Bankruptcy Liquidations

In the context of a bankruptcy, the BIA is intended to deal primarily with the bankrupt's unsecured creditors. The right to file a claim and receive a dividend in the distribution of the proceeds derived from the liquidation of the bankrupt's unencumbered assets replaces all of the pre-bankruptcy remedies available to unsecured creditors. The bankrupt's secured creditors, on the other hand, have the ability to enforce their security outside of the bankruptcy, generally through the appointment of a receiver. While there is some limited ability to bring secured creditors into the bankruptcy process, secured creditors normally proceed to enforce their security without regard to the bankruptcy and turn whatever excess proceeds may exist, once their secured claims have been satisfied, over to the trustee to be distributed among unsecured creditors in the bankruptcy.

1. Initiation of the Bankruptcy

An insolvent debtor can initiate a bankruptcy itself by filing an Assignment for the general benefit of its creditors with the official receiver[3] (the official appointed by the federal government to oversee the administration of bankruptcies and reorganizations taking place under the BIA.) The Assignment itself is a standard-form document pursuant to which the debtor assigns all of its property to a bankruptcy trustee to be administered as required by the BIA. Unsecured creditors can also force an insolvent debtor into bankruptcy by applying to the court by way of Petition[4] seeking an order declaring that the debtor is bankrupt and appointing a trustee over its property. Finally, a bankruptcy automatically results if an attempt by an insolvent debtor to reorganize under the BIA is unsuccessful[5].

2. Stay of Proceedings

Once a bankruptcy has commenced, the rights of unsecured creditors to pursue their claims against the bankrupt or its property are stayed[6]. Unsecured creditors can apply to the court for relief from the stay to pursue their remedies against the bankrupt and/or its assets. However, to be successful, the unsecured creditor must establish that it is being prejudiced by the stay or that other equitable grounds exist that warrant the leave. As a general rule, it is extremely difficult for an unsecured creditor to obtain leave from the stay in order to pursue an action or to take steps to enforce its claim.

However, the bankruptcy stay does not generally impact secured creditors[7]. The BIA permits the court to temporarily suspend a secured creditor's right to enforce its security and restricts the ability of a secured creditor to realize its security in circumstances where

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3 BIA s. 49.

4 BIA s. 43.

5 BIA s. 50.4(8) (failure to file cash flow or proposal), s. 57 (creditors do not accept the proposal), s. 61(2) (court refuses to approve proposal) and s. 63(4) (annulment of proposal as a result of default).

6 BIA s. 69.3(1).

7 BIA s. 69.3(2).

the collateral is held by the secured creditor and the bankruptcy trustee wishes to inspect the collateral. However, in actual practice, this rarely happens[8].

3. Administration of the Bankruptcy

Whether a debtor files an Assignment, the debtor is declared bankrupt on the Petition of a creditor or the debtor becomes bankrupt as a result of a failed reorganization, the bankruptcy has the effect of vesting all of the debtor's unencumbered property in the bankruptcy trustee. The property that vests in the trustee includes not only tangible property but also choses in action, rights under contracts, etc.

While rarely used, the trustee has the power to continue the bankrupt's business "for the beneficial administration of the estate"[9]. As a practical matter it is extremely rare for a bankruptcy trustee to continue the bankrupt's business. If the intention is to carry on the business of the insolvent debtor, it is generally the case that the secured creditor will either appoint a receiver privately or seek a court order appointing a receiver to do so. If a bankruptcy trustee does carry on the bankrupt's business the trustee is generally personally liable for goods and services purchased or contracts entered into while carrying on the business.

4. Recovery of Property

The trustee is only vested in property beneficially owned by the bankrupt. If the bankrupt is in possession of property owned by another party, ie. intellectual property or customer information, the BIA provides for the recovery of that property. The BIA requires that a person asserting an ownership interest in property file a Proof of Claim (Property) asserting the proprietary interest in the specified property.[10] The claimant bears the burden of establishing that it owns the property.

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[8] See BIA s. 69(2)(a) and (b) and s. 79.

[9] BIA s. 30(1).

[10] BIA s.81

5. Impact of Bankruptcy on Contracts

Intellectual property is typically the subject of contractual arrangements between companies, usually in the form of license agreements. Where the party owning or creating the intellectual property becomes bankrupt, third parties holding licenses from the bankrupt will be concerned to preserve their licensing rights, notwithstanding the bankruptcy. Conversely, where the licensee becomes bankrupt, the solvent licensor will generally wish to terminate the contract to enable it to take back the rights contained in the license agreement and dispose of them to a different party in the public marketplace, rather than having the trustee maintain the benefits under the license and dispose of them independently without the licensor's consent. Unfortunately, the BIA is not clear on how contracts, including these types of licence agreements, are impacted by the bankruptcy of one of the parties to the contract.

a. Retention of Contracts by a Trustee

A bankruptcy does not, in and of itself, automatically terminate a contract or constitute a breach of that contract except in the case of contracts which are personal in nature, such as employment contracts. If it so chooses, therefore, a bankruptcy trustee is generally entitled to perform a contract and to require the other party to perform it. However, if the trustee does not perform under a contract within a reasonable period of time, the other party to the contract can treat the contract as broken[11].

In an attempt to prevent a bankruptcy trustee from enforcing a contract after bankruptcy, agreements will often provide for an automatic termination of the agreement on bankruptcy, or will provide for bankruptcy to constitute an event of default. The BIA contains no legislative provisions specifically staying the enforcement of such automatic termination or default clauses in the case of a bankruptcy. However, most insolvency practitioners are of the view that such clauses are not enforceable against a bankruptcy

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[11] L.W. Houlden and G.B. Morawetz, *The 2002 Annotated Bankruptcy and Insolvency Act* (Carswell) at Fδ45.2.

trustee. In *Canadian Imperial Bank of Commerce v. Bramalea Inc.*[12] the court dealt with the enforceability of a clause in a partnership agreement triggered by insolvency or bankruptcy alone, which purported to allow a solvent partner to purchase the insolvent partner's interest for less than its fair market value. Blair J. found that such a contractual provision is not enforceable and is void on the basis that it violates public policy where it has the effect of depriving the creditors of value.

It is, therefore, likely that other events of default will have to be relied upon by a licensor when attempting to terminate a license agreement where a bankruptcy trustee for the licensee attempts to retain the license.

b. Disclaimer of Contracts by a Trustee

The opposite situation arises in circumstances where the bankrupt has by contract granted rights in its property to a third party, and the third party wishes to prevent the bankruptcy trustee from disclaiming that contract. Although the BIA contains no provision that directly permits the trustee to disclaim commercial contracts, the English case law appears to suggest that a bankruptcy trustee may disclaim a commercial contract[13], and in practice trustees routinely do so.

However, one reported case that suggests that if a bankruptcy trustee has the right to disclaim commercial contracts, it cannot disclaim a contract that has the effect of transferring property. In *Re Erin Features No. 1 Ltd*., the British Columbia Supreme Court decided that a bankruptcy trustee could not disclaim a contract granting exclusive marketing rights to a film because the contract was actually a transfer of property[14]. Prior to its bankruptcy, the bankrupt had negotiated an agreement that granted exclusive marketing rights in Canada to Modern Cinema Marketing Ltd. for a film entitled Lighthouse. After the bankruptcy, the trustee sought to terminate this agreement.

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[12] 44 B.L.R. (2d) 188 (Ontario Court of Justice).

[13] See L. Duncan *and* J.D. Honsberger Bankruptcy in Canada (3d) (Canada Law Book, 1961) at 136 and 333. See, however, M.J. Forte and A.C. Chester "Licenses and the Effect of Bankruptcy and Insolvency Law on the Licensee" included in the materials for the Turnaround Management Association's Third Annual Symposium (February 1, 2001).

[14] *Re Erin* Features *No. 1 Ltd.* (1991), 8 C.B.R. (3d) 205 (B.C.S.C.).

However, the court characterized the arrangement as a sale by Erin of property, namely the exclusive right to market the film. As a result the contract could not be disclaimed by the trustee[15].

It should be noted that it is generally accepted by information technology and intellectual property practitioners that a transfer of a license does not constitute a transfer of property. Specifically, a license has been described as nothing more than permission from the licensor to the licensee to make use of its intellectual property[16]. As a result, it seems to be possible for a bankruptcy trustee to disclaim a license, leaving the affected licensee with nothing more than an unsecured claim in the bankruptcy for damages resulting from the termination.

6. Assignment of Contracts by Trustee

The issue of disclaimer is probably more theoretical than real in the context of most license agreements since the primary role of a bankruptcy trustee is to maximize the value of the estate for creditors. Assuming that the license grant provides a continued income stream to the bankrupt into the future, the trustee is not likely to disclaim contracts but rather to attempt to preserve them as part of the bankrupt's unencumbered property that the trustee will attempt to assign as part of the asset sale to increase the proceeds available for distribution to creditors. In the context of a bankruptcy involving intellectual property or intellectual technology assets, the issue is likely to be whether the purchaser acquires property, such as technology, subject to, or free of, rights, such as licenses, that were granted in that property by the bankrupt. In that context, the key issue is whether or not the trustee can assign contracts to a purchaser, such as software licenses, without the consent of the other party to the license agreement.

The BIA is silent with respect to a bankruptcy trustee's general ability to assign a contract, but there is nothing to suggest that the ordinary common law with respect to the

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15 *Re Erin* Films has been criticized -- see G.G.S. Takach and E.L. Hayes "Case Comment" 15 C.B.R.(3d) 66. However, the criticism has related to whether property was conveyed and not with the concept that a pre-bankruptcy contract that has the effect of conveying property cannot be disclaimed. An exception would be if the conveyance was a settlement or preference.

16 W.A. Adams and G.G.S. Takach "Insecure Transactions" 33 C.B.L.J. 321 at 350.

assignment of contracts would not apply to such an assignment by a bankruptcy trustee. However, *Bramalea* suggests that contractual clauses that restrict assignment in an insolvency are not enforceable.

The general common law test with respect to the reasonableness of a refusal to consent to an assignment has two parts[17]:

(a) first, the court must determine the basis for the refusal to consent; and

(b) having determined the basis for the refusal to consent to the assignment, the court will then determine whether that basis is reasonable.

In determining whether consent is unreasonably withheld the court will also consider the following:

(a) the covenant in the agreement and its purpose in that context;

(b) all of the circumstance of the case including the commercial realities of the market place and the economic impact of the assignment on the non-assigning party;

(c) the non-assigning party is not entitled to refuse his consent so as to be able to acquire a further commercial benefit for himself by insisting on conditions which were outside of the original agreement and thus obtain more advantageous terms; and

(d) it is unreasonable for the non-assigning party by withholding his consent and insisting on different terms and conditions, to rewrite *ex post facto* the assignment covenant which it and the parties had previously freely negotiated.[18]

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17 *Lehndorff Canadian Pension Properties Ltd.* v. *Davis Management Ltd.,* [1987] B.C.J. No. 1228 (Sup. Ct.), aff'd [1989] B.C.J. No. 990 (C.A.) at para 51. See also *Welch Foods Inc.* v. *Cadbury Beverages Canada Inc.* [1999] O.J. No 544 (Gen. Div.), aff'd [2001] O.J.

18 *Jo-Emma* Restaurants *Ltd.* v. *A. Merkur and Sons Ltd.* [1989] O.J. No. 1803, 7 R.P.R. (2d) 298 (Dist. Ct.) at p. 3

It is important to point out that the failure to respond to a request to assign a contract can, in and of itself, be considered unreasonable.[19] For example, the Alberta Court of Queen's Bench has found that: "[…] Notice of Termination is not an answer to the request for consent. The [Landlord] is obliged to state reasons for withholding its consent" and "[…] failure by [Landlord] to answer the request for its consent, except to issue a Notice of Termination…, without more and without further explanation, provides no reasons for withholding consent. Obviously that is tantamount to an unreasonable withholding of its consent."[20]

There are no bankruptcy cases on this issue. The application of these cases in an insolvency has, however, been considered in the context of a CCAA restructuring and is discussed later.

7. Property Rights on Asset Sales by Trustee

Where transfers of assets occur in a bankrupt estate, the BIA provides that sales of property by the bankruptcy trustee vest in the purchaser all of the legal and equitable estate of the bankrupt in that property[21]. Acquisitions from a bankruptcy trustee will, therefore, be subject to certain interests in the bankrupt's property held by third parties[22]. These would include, for example, proprietary interests that may exist in favour of third parties, since the bankruptcy is not able to impact those property rights. This issue was recently considered by the Alberta Court of Appeal in *Bank of Montreal* v. *Dynex Petroleum Ltd.*[23] The issue in *Dynex* was whether the sale of oil and gas properties by a bankruptcy trustee would be subject to overriding royalty interests (an unencumbered share or fractional interest in the gross production from an oil and gas property) granted

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19 *Cornish* v. *Boles* (1914), 31 O.L.R. 505 (C.A.). *St. Jane Plaza Ltd.* v. *Sunco Inc.*, [1992] O.J. No. 1339 (Gen. Div.) at p. 4.

20 *Zurich Canadian Holdings Ltd. v. Questar Exploration Inc.* [1998] A.J. No. 609 (Alta Q.B.) at paras 64 and 66.

21 BIA s. 84.

22 It should be noted that courts have, for practical reasons, made orders in the context of a bankruptcy vesting assets in a purchaser free and clear of the claims of secured creditors and statutory deemed trusts. These types of orders are typically made in situations where the amount owing by the bankrupt in respect of unremitted source deductions is in excess of the purchase price being paid for the assets.

23 182 D.L.R. (4th) 640 (Alberta Court of Appeal).

by Dynex. Specifically, the question was whether an overriding royalty interest could be an interest in land, as opposed to a chose in action that gave rise to an secured or unsecured claim in the bankruptcy. A decision that was upheld by the Supreme Court of Canada analysed the function of royalty interests and the way they were treated in the oil and gas industry as a matter of practice. The court determined, in a departure from the traditional common law view, that overriding royalty interests could be interests in land. As a result, the purchaser in this case acquired the properties subject to the royalty interests.

8. Sale of Patented and Copyrighted Property

While the BIA contains no provisions respecting trade-marks, industrial designs or plant breeder's rights, it does deal with the sale by a bankruptcy trustee of patented articles and copyrighted materials.

Section 82 of the BIA deals with the sale of patented articles. Pursuant to this section, a bankruptcy trustee can sell patented articles that were sold to the bankrupt subject to restrictions or limitations free and clear of those restrictions or limitations[24]. However, the act balances the rights of the manufacturer or vendor of patent articles and the trustee by giving them the right to purchase the articles from the trustee[25].

Section 83 of the BIA makes provision for how a bankruptcy trustee may deal with copyrighted materials or interests in copyrights assigned to the bankrupt. Subsection 83(1) deals with situations where the copyrighted work has not been published and put on the market prior to the bankruptcy, and subsection 83(2) deals with the situation where the copyrighted work has been published and put on the market.

According to subsection 83(1), if no expenses have been incurred in connection with the copyrighted work, then the work must be returned to the author and any agreement between the author and the bankrupt automatically terminates and becomes void. If, on the other hand, expenses have been incurred by the bankrupt in connection with the

[24] BIA s. 82(1).

[25] BIA s. 82(2).

copyrighted work, the author may pay those expenses to secure the return of materials and the termination of the contract. If the author does not wish to pay the expenses incurred by the bankrupt, the trustee has six months to carry out the contract between the bankrupt and the author before the agreement terminates and becomes void.

If the copyrighted works were published and put on the market at the time of the bankruptcy, the bankruptcy trustee may sell copies of the published work subject to certain restrictions[26]. The trustee must pay any royalties or share of profits to which the author would be entitled and before selling copies of the copyrighted materials, the bankruptcy trustee must offer to sell all of the copies to the author[27]. Once all of the copies of the published work have been sold, the contract between the bankrupt and the author terminates and becomes void.

The trustee may not assign or license the copyrighted materials except on terms that guarantee that the author will receive any royalties or share of profits to which the author would be entitled. However, if appropriate guarantees are provided, the consent of the author to an assignment by the trustee is not required[28] and it appears that the trustee can assign notwithstanding any terms in the agreement that restrict the assignment of copyrighted materials.

IV. Reorganizations

As mentioned above, there are two separate reorganization regimes in Canada -- BIA reorganizations (known as "proposals") and CCAA reorganizations. BIA proposals are generally used in smaller insolvencies and the regime is fairly rigid due to the fact that the BIA provides a complete code for the restructuring. There is very little room for creativity in the BIA proposal process.

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[26] BIA s. 83(2).

[27] BIA s. 83(3).

[28] *Re Song Corp.* (January 7, 2002) File No. 31-388643 (Ont. S.C.J.)

1. BIA Proposals

a. Initiation of BIA Reorganizations

Under the BIA, reorganizations are most commonly initiated by filing a standard-form document called a Notice of Intention to Make a Proposal naming a bankruptcy trustee who has consented to supervise the debtor while it attempts to develop a reorganization plan, known as a proposal.

In a BIA proposal the insolvent debtor generally remains in possession of its assets and continues to manage its business and affairs. The function of the trustee is to monitor the debtor's financial situation and report any material adverse changes to the court. The trustee does not interfere in the operation of the debtor's business. If there is a need for greater supervision, the court has the jurisdiction to appoint an interim receiver to provide more active monitoring or to take control of the debtor's assets and business operations.

For a proposal to be accepted, a majority of the creditors in each class of unsecured creditors must vote in favour of it, while holding two thirds in value of the total debt represented by that class. Secured creditors do not directly influence the approval of the proposal by the unsecured creditors, but if a class of secured creditors does not independently approve of the proposal they are no longer bound by the stay and are free to deal with their collateral as they wish. Rejection by a class of secured creditors can, therefore, seriously jeopardize the possibility that the debtor will be able to continue as a going concern and, as a practical matter, rejection by secured creditors will often spell the end of a reorganization. Once a proposal has been accepted by the creditors, it must be approved by the court before it becomes binding.

As discussed above, the failure of a proposal results in the automatic bankruptcy of the insolvent debtor. If, for example, the creditors do not vote to accept the debtor's proposal or the court refuses to approve of the proposal, the debtor is deemed to have made a voluntary assignment in bankruptcy.

b. Stay of Proceedings

Once the debtor files a Notice of Intention, an automatic thirty day statutory stay of proceeding arises that prohibits the creditors, both secured and unsecured, from exercising any remedy against the debtor or its property, or from commencing or continuing any action, execution or other proceeding for the recovery of a claim provable in bankruptcy[29]. This stay, and the time for filing a proposal, can be extended by the court in forty-five day blocks for a maximum period of six months[30].

A secured or unsecured creditor may apply for relief from the stay when it can satisfy the court that:

(a) the creditor will be materially prejudiced by the continued operation of the stay; or

(b) it is equitable on other grounds to grant that creditor relief from the stay.

The burden of proof in an application for relief from a stay in a BIA reorganization falls on the creditor and it is generally seen as a difficult burden to meet. A creditor seeking relief from the stay must establish that its indebtedness or, in the case of a secured creditor, its security, is at risk or that there has been some improper conduct on the part of the debtor. As a general rule, unsecured creditors will rarely be able to obtain leave to pursue actions against a reorganizing debtor.

A creditor may, at any time, apply to the court asking that the reorganization process be terminated if it can satisfy the court that:

(a) the debtor has not acted or is not acting in good faith and due diligence;
(b) the debtor in not likely to be able to make a viable proposal; or
(b) the creditors as a whole would be materially prejudiced if the proposal process was not terminated.

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[29] BIA s. 69.1.

[30] BIA s. 50.4(9).

c. Doing Business With the Reorganizing Debtor

The BIA prohibits parties to existing contracts with the reorganizing debtor from terminating contracts or discontinuing service on the basis only that the debtor is insolvent, has commenced a reorganization or, in the case of leases, licenses and utilities, has failed to make a payment due prior to the commencement of the reorganization[31]. It is impossible to contract out of these provisions, but the court may declare that they do not apply if the other party to the contract satisfies the court that the operation of the provisions would likely cause "significant financial hardship."[32] There are no reported cases dealing with what constitutes a significant financial hardship.

It is important to note that parties who are prevented from terminating contracts are not restricted from terminating on the basis of non-insolvency defaults and are not required to extend further credit to the debtor. Moreover, they can demand immediate payment for goods and services delivered or supplied after the commencement of the reorganization[33]. In *Re Cosgrove-Moore Bindery Services Ltd.*[34] the Court considered s. 65.1(4) of the BIA, the provision which permits suppliers to require immediate payment for goods and services supplied, and the use of leased property subsequent to the filing of a Notice of Intention. In that case the company's landlord and an equipment lessor made motions seeking orders requiring that the debtor make immediate payment for use of the leased property. The court found that the purpose of s. 65.1 was "to provide a commercial enterprise with the opportunity to continue operations while working toward a reorganization while at the same time to give creditors obligated to continue to supply goods, services or the use of leased property some protection that payments ordinarily due during the proposal period will not be wiped out or reduced to pro rata unsecured claims in the event of an ultimate bankruptcy." The court also found that suppliers were not required to commence actions to recover amounts owing and ordered that the debtor make immediate payment under the leases going forward.

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31 BIA s. 65.1(1), (2) and (3).

32 BIA s. 65.1(5) and (6)

33 BIA s. 65.1(4).

34 (2000), 17 C.B.R. (4th) 205 (Ont. S.C.J.).

Unfortunately if a reorganization is not successful, suppliers who have not been paid for goods or services supplied during the reorganization are unlikely to receive payment. As mentioned above, in the case of a BIA reorganization if the reorganization fails the debtor is deemed to have made a bankruptcy assignment as of the date of the event that triggers the failure. The BIA does not contain any provisions that protect creditors who supplied to the debtor in the period between the commencement of the reorganization and the deemed assignment. In the BIA distribution scheme such creditors will be treated as ordinary unsecured creditors.

The decision in *Pike* v. *Bel-Tronics Co.*[35] provides an unfortunate example of the risk of supplying goods and services to a reorganizing debtor. Bel-Tonics Co. filed a Notice of Intention. The proposal was rejected by the company's creditors and as a result, the company was deemed to have made a bankruptcy assignment. Bel-Tronics owed its suppliers a substantial sum of money for goods supplied subsequent to the filing of the Notice of Intention. The bankruptcy trustee, supported by one unpaid supplier, made a motion seeking an order requiring that the receiver appointed by the secured creditor pay amounts owing to these suppliers. The court ultimately found that the unpaid suppliers would be unsecured creditors in this bankruptcy.

There are a number of business solutions that can be used to protect suppliers from the risk that the debtor's reorganization may fail. For example, suppliers may insist on payment in advance or payment on delivery, or may insist that the company provide a standby letter of credit. Sometimes suppliers can make arrangements with the debtor for payment to be made via wire transfer in advance of fulfilling the company's orders. The ability of a supplier to negotiate these sorts of arrangements will depend on a number of factors including the importance of the supplier's goods and services to the debtor's ability to carry on business, and whether the suppler is party to a pre-existing supply contract with the debtor (parties to contracts with a reorganizing debtor are generally stayed from terminating or amending such contracts.)

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[35] (2000), 19 C.B.R. (4th) 262 (On. S.C.J.).

d. Disclaimer of Contracts

With one exception, the BIA is silent with respect to the ability of a reorganizing debtor to disclaim contracts. The BIA permits a reorganizing debtor to disclaim real property leases and to make provision for any damages caused by the disclaimer in its proposal[36].

In the event that a reorganizing debtor were to terminate a contract after filing a Notice of Intention, any damages suffered by the other party to the contract would most likely not be subject to the proposal. Rather, they would not be compromised and the debtor would remain liable for the damages notwithstanding its reorganization. This is because in a BIA reorganization (unlike the CCAA) claims are determined as at the date of the filing of the Notice of Intention[37]. Arguably, any claim arising from a termination after that date would not be subject to the proposal. This is one of the primary reasons why most large corporations will seek to reorganize under the CCAA rather than the BIA, since the termination of unprofitable contracts is often a major component of a typical restructuring strategy.

e. Selling Assets/Assigning Contracts

The BIA, not surprisingly, does not deal with the sale of assets or assignment of contracts by a reorganizing debtor. That being said, it is clearly possible for a reorganizing debtor to sell assets or assign contracts and seek an order vesting those assets and/or contracts in a purchaser free and clear, during the restructuring process. In this type of transaction, the same issues will exist with respect to the ability of the court to vest assets free and clear of interests arising under contract as will be discussed below in the context of CCAA reorganizations.

2. CCAA Reorganizations

Rather than provide detailed substantive and procedural provisions to govern all aspects of the reorganization, the CCAA provides only a general framework for the

[36] BIA s. 65.2

[37] BIA s. 62(1.1). If a proposal is filed, as apposed to a Notice of Intention, the date for determining claims is the date of the proposal.

reorganization of a insolvent business. The details of the reorganization process are established by the court through orders made during the restructuring process. The result is a flexible regime that can be adapted to suit the specific needs of the insolvent company. As a result, the CCAA is the reorganization regime of choice for complicated reorganizations due to its flexibility.

a. Initiation of CCAA Proceedings

A CCAA reorganization is commenced by either the debtor or a creditor making an application to the court for protection while a reorganization is developed (creditor initiated reorganization are rare). The commencement of the proceeding is discretionary on the part of the court, and the debtor is required to establish the existence of circumstances that make an order under the CCAA appropriate. In general terms, provided the debtor company can establish that it meets the requirements of the CCAA, the burden will be upon opposing creditors to show why the court should not permit the reorganization to proceed.

During a CCAA reorganization, the debtor usually continues to conduct its business under its existing management. However, the CCAA requires that a monitor be appointed to oversee the debtor's reorganization and report back to the creditors and the court. Monitors perform essentially the same function under the CCAA as trustees in BIA reorganizations. However, the exact role that the monitor plays is ultimately determined by the court.

For purposes of CCAA arrangements, the creditors are divided into classes and vote on the plan presented by the debtor on a class-by-class basis. The majority required to accept a plan is the same as under the BIA: two-thirds in value and a majority in number. If the required majority is not achieved in a class, the plan is not binding on the creditors of that class. Once accepted by the creditors, a plan must be approved by the court before it becomes binding on the company's creditors.

b. Stay of Proceedings

The CCAA provides for an initial stay of proceedings for a period up to thirty days, prior to the expiry of which the debtor may request an extension. Usually the initial stay is obtained by the debtor on an "ex-parte" basis, and the court will require service of the supporting materials on all creditors prior to the first extension hearing which is usually referred to as the "comeback" or "confirmation" hearing. When seeking any extension, the burden is on the debtor to establish not only that the stay is appropriate, but that it has acted and is acting in good faith and with due diligence. There are no statutory restrictions on the period for which the stay can be extended.

As a result of the courts having interpreted the stay provisions of the CCAA broadly in order to protect the integrity of the debtor's business, the scope of the stay generally granted by the court in CCAA reorganizations is quite broad.

c. Doing Business with the Reorganizing Debtor

It is common for a CCAA order to include extensive stay provisions that prevent suppliers from terminating or amending agreements with the reorganizing debtor on any basis whatsoever. These provisions are typically much more extensive than the comparable sections of the BIA. However, section 11.3 of the CCAA parallels subsection 65.1(4) of the BIA and provides that "no stay of proceedings granted under the CCAA can have the effect of prohibiting a person from requiring immediate payment for goods, services or the use of leased or licensed property, or requiring the further advance of money or credit"[38].

The CCAA, like the BIA, is silent as to the treatment of suppliers who supplied goods and services to a reorganizing debtor and generally these creditors will be ordinary unsecured creditors. The CCAA, unlike the BIA, does not provide for a deemed bankruptcy in the event that a attempt reorganization is unsuccessful. Nonetheless, as a practical matter, the failure of a CCAA reorganization will, more often than not, result in a liquidation of the debtor.

38 CCAA s. 11.3.

In addition to the negotiated compromises found in BIA reorganizations to protect suppliers, the exercise of inherent jurisdiction by the court and the flexibility of the CCAA process make it possible for the court to create structures that limit a suppliers' risk exposure during a CCAA reorganization. For example, in the CCAA reorganization of *Smoky River Coal Ltd.*, the Alberta Court of Queens' Bench made an order which created a charge, limited to $7 million, over the debtor's property to secure amounts owing to "Post-Petition Trade Creditors"[39]. The charge was created to encourage the debtor's regular trade creditors to continue to provide essential goods and services during the company's reorganization. The order made in Smoky River Coal was similar to the Order made by the British Columbia Supreme Court in the 1992 reorganization of Westar Mining Ltd. In *Re Westar Mining* the court made an order granting suppliers a priority charge to secure credit supplied during the restructuring.[40] Specifically, the judge stated that "the essential problem here is how to enable the company to continue operating until September 30, 1992. … I accept the argument that the most equitable compromise is to make security over [the debtor's assets], with the highest possible priority, available to those who will finance the company's continuing operations."

At the conclusion of a successful CCAA reorganization, the "sanction" order of the court approving the restructuring plan typically contains a provision which compels the parties to all executory contracts to honour such contracts in accordance with their terms on the basis that all insolvency or financial defaults existing at the date of the proceedings or created as a result of the proceedings are deemed to have been cured by the restructuring process. The contracting party is thereby prevented from terminating a contract after the stay of proceedings terminates. The contracting party is instead limited to an unsecured claim under the restructuring plan for any damages resulting from such defaults.

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[39] See Re Smoky River Coal Ltd. (2000), 19 C.B.R. (4th) 281 (Alts. Q.B.).

[40] See *Re Westar Mining Ltd.* (1992), 70 B.C.L.R. (2d) 6 (S.C.) and *Re Companies' Creditors Arrangement* Act (1993), 30 C.B.R. (3d) 119 (B.C.S.C.).

d. Termination of Contracts

Although not specifically provided for in the legislation, it is standard practice for CCAA orders to permit the reorganizing company to terminate or disclaim contracts during the course of the restructuring. These orders generally provide for any damages resulting from any termination of a contract by the debtor to be an unsecured claim in the reorganization. For example, in *Re Blue Range Resources Corp.,*[41] the Court found that an order authorizing the terminations of contracts was appropriate in a restructuring. Similarly, the Ontario Superior Court of Justice has stated that "[i]t is clear that under CCAA proceedings debtor companies are permitted to unilaterally terminate in the sense of repudiate leases and contracts without regard to the terms of those leases and contracts …" [42] In commenting on the situation facing parties to contracts terminated by a reorganizing debtor, the court in *Re Blue Range* observed, quite correctly, that the other parties to terminated contracts "will be relegated to the ranks of unsecured judgment creditors and may not, indeed likely will not, have their judgments satisfied in full."

It appears that the threshold question in an attempt to disclaim or terminate a contract in a CCAA may be whether that contract had the effect of transferring an interest in property. In *Re T Eaton Company Limited* [43] the court implied that a debtor could not disclaim a contract that vested property rights in the other party to the contract.

e. Assignment of Contracts

The law with respect to the assignment of commercial contracts which has developed outside of insolvency has been applied in CCAA reorganizations.

In *Re American Eco Corporation*[44] the court applied the reasoning in *Welch Foods* in the CCAA context where the court was asked to force the assignment of a joint venture contract. It appears that the contract party was asking for some form of bonus as a

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[41] (1999), 245 A.R. 154 (Alta. Q.B.).

[42] *Re T. Eaton Company Limited* (1999), 14 C.B.R. (4th) 288 (Ont. Sup. Ct.).

[43] See argument in *Re T. Eaton Company Limited* (1999), 14 C.B.R. (4th) 288 (Ont. Sup. Ct.).

[44] (October 24, 2000), Court File No. 00-CL-3841 (Ont. Gen. Div.).

condition to providing its consent to the assignment. The court found that there was no "financial or operational reason" for the refusal to consent to the assignment and that "in the circumstances prevailing of the insolvency that [the contract party] is attempting to confiscate value which should otherwise be attributable to the creditors" and permitted the assignment without consent.

In *Re Playdium Entertainment Corp.*,[45] the court also considered the assignment of a contract in the context of a CCAA reorganization. After an unsuccessful attempt by Playdium to restructure, a plan to save the company's business was put forward by the company's secured creditors. The plan provided for substantially all of Playdium's assets including its materials contracts, to be transferred to a new corporation called Newco, controlled by the secured creditors. Newco would then continue to operate the business as a going concern. The plan was to be implemented by appointing an interim receiver over Playdium's assets to effect the transfer.

Among the contracts to be transferred to Newco was a contract with Famous Players Inc. Famous Players refused, however, to consent to the assignment of this contract to Newco because Playdium was in default under the contract, a proper request for consent to the assignment of the contract to Newco had not been made, and adequate financial information and assurances as to the management of Newco and information respecting how the agreement was to be brought into good standing had not been provided. A motion was brought by the secured creditors seeking an order implementing the plan and compelling the assignment of the Famous Players agreement to Newco. This motion contemplated that from the assignment date, Newco would become bound to perform Playdium's obligations under the contract and would be entitled to require Famous Players to perform its obligations, and Famous Players would be entitled to exercise contractual termination rights based on defaults arising or continuing after the assignment date.

[45] [2001] O.J. No. 4252 (Sup. Ct.) with additional reasons at [2001] O.J. No. 4459 (Sup. Ct.). See also "Secured Creditors Lead Playdium *CCAA* Restructuring" *Lexpert* (March, 2002) 57.

In considering whether to compel the assignment of the contract to Newco, the court addressed both its jurisdictional powers to make an order compelling the assignment of the contract to Newco and whether it was appropriate, in the circumstance, to make such an order[46].

After analysing the case law concerning the application of the provisions of the CCAA that permit the court to stay proceedings and to exercise inherent jurisdiction under the CCAA, the court found that having regard to the purpose of the CCAA (to facilitate a reorganization to allow the business to continue) and the necessary inference that the stay provisions were to be used to advance that purpose, the jurisdiction existed to make an order compelling the assignment.

Prior to deciding whether it was appropriate to compel the assignment of the agreement to Newco, the court found that Famous Players was refusing to consent to the assignment to Newco because of Playdium's continuing defaults under the agreement and because of the prospect of a better deal with another party. The court found that, although it would be reasonable for Famous Players to refuse its consent to the assignment of the contract to Newco outside of the CCAA context, in the context of a CCAA restructuring it was appropriate to compel the assignment of the contract.

It remains to be seen whether the court will apply the reasoning in *American Eco* and *Playdium* to insolvency situations other than CCAA reorganizations. It also remains to be seen whether the courts will expand the circumstances in which it will compel the assignment of contracts to situations where the contract, by its terms, is not assignable or where consent to assignment can be arbitrarily withheld.

V. Court-Appointed Receivers

In the insolvency context, receivership is generally regarded as a secured creditor's remedy. A receiver can be appointed to take possession of a debtor's assets either by a secured creditor pursuant to powers granted in a security agreement or by the court

46 The analysis with respect to jurisdiction appears in the supplementary reasons issued after an additional hearing.

Because both receivership and bankruptcy may arise in the context of an insolvency, there is often some confusion between the two concepts. The confusion between bankruptcy and receivership is further complicated by the fact that it is possible for a trustee in bankruptcy to be appointed receiver by a secured creditor with security over the bankrupt's assets[47]. It is important to recognize however, that receivership, as a remedy, is not synonymous with bankruptcy and that the two are separate and distinct remedies notwithstanding that they can, and often do, occur contemporaneously.

A court-appointed receiver is an officer of the court and the scope and extent of its powers will be determined by the order pursuant to which it is appointed. It is common for orders appointing receivers to include provisions staying proceedings against the debtor's property, hence permitting the receiver to operate the debtor's business and restricting the ability of parties to contract with the debtor from terminating or amending those contracts. Receivership orders will also typically include provisions that allow the receiver to market and sell the debtor's assets either as a going concern or piecemeal.

Generally speaking, a court-appointed receiver is not bound by the debtor's contracts and, subject to the provisions in the receivership order pursuant to which it was appointed, may disclaim contracts. However, a decision of the Alberta Court of Queens Bench calls into question whether a court-appointed receiver could disclaim contracts without regard for the impact of that disclaimer on the other party to the contract.

In *Bank of Montreal v. Probe Exploration Inc.*[48], the court was called upon to consider whether it was appropriate for a court-appointed receiver to terminate contracts where the effect of the termination would increase the realizable value of the company's assets, but would cause serious damage to the other party to the contract. The court found that a court-appointed receiver owes an obligation to all stakeholders and would not permit the terminations. On appeal, the Alberta Court of Appeal upheld the lower court's decision[49]. It is not clear, however, to what extent this decision will be followed in the

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47 BIA s. 13.4.

48 (May 15, 2000) Court File No. 0001-02917 (Alta. Q.B.)

49 2000 Carswell Alta 1621 (Alta. C.A.).

receivership context or whether the reasoning in the case will be considered in the CCAA context.

It may also be the case that parties to contracts with an insolvent debtor in receivership can seek to have the receiver bound by these contracts. In *Coopérants, Société mutuelle d'assurance-vie* c. *Raymond, Chabot, Faford, Gagnon Inc.*[50], the Supreme Court of Canada found that a liquidator under the Winding-up and Restructuring Act[51] – what they analogized to a receiver appointed by the court – was in a different position than a bankruptcy trustee and would be bound by an agreement that provided for specific obligations arising in the event of insolvency. It should be noted, however, that the court did not have any evidence with respect to the value of the assets in question. Moreover, it is unclear if this case would be followed where the court has ordered that a receiver may disclaim contracts.

VI. Interim Receivers

The interim receiver is a creation of the BIA. The BIA provides for the optional appointment of a bankruptcy trustee as an "interim receiver" to preserve the property of an insolvent debtor pending the hearing of a Petition[52], or to preserve the interests of a secured creditor pending the enforcement of security[53], or to preserve a reorganizing debtor's property or the interests of creditors generally in a reorganization[54]. The court has a broad jurisdiction under the BIA in that context to direct an interim receiver to take possession and exercise control over the debtor's property and business, and "take such other actions as the court considers advisable."[55]

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[50] (1996) 39 C.B.R. (3d) 253 (S.C.C.).

[51] R.S.C. 1985 c. W-11, as amended.

[52] BIA s. 46.

[53] BIA s. 47. Section 244 of the BIA requires that a secured creditor enforcing security over all or substantially of an insolvent debtor's inventory, receivables or other property provide that debtor with ten day's notice.

[54] BIA s. 47.1.

[55] BIA s. 47(2)(c) and s. 47.1(2)(d).

In recent years, the interim receiver role has evolved to that point that it now serves a function that goes far beyond the preservation of the insolvent debtor's assets. The concept has also been used in the context of some CCAA proceedings, particularly where an asset liquidation is the result of the restructuring attempt. One of the more common applications of an interim receiver is to facilitate the sale of assets located in more than one jurisdiction or to "avoid" some of the adverse consequences of a court-appointed receiver, such as the application of the rights of unpaid suppliers to recover goods shipped to the insolvent debtor[56]. As mentioned above, the secured creditors in *Playdium* accomplished the transfer of the company's assets through the appointment of an interim receiver.

In practice, it is not unusual to see interim receivership orders that include comprehensive stays of proceedings and provisions restricting the termination of contracts. In this respect, they often resemble orders made under the CCAA or in conventional receivership proceedings.

VII. Insolvency Reform

The federal government is currently engaged in a process to review Canada's insolvency legislation, with the intention of presenting amendments to both the BIA and the CCAA to Parliament for its consideration later this year.

Although it is impossible to predict what specific amendments, if any, might arise from this latest insolvency review process, a joint proposal from the Insolvency Institute of Canada and the Canadian Institute of Insolvency and Restructuring Professionals has recommended several amendments which, if accepted, might assist in bringing more clarity to some of the issues facing parties affected by the insolvency of a corporation carrying on business in a knowledge based industry. For example, the proposed amendments include a much more detailed regime for the adoption or disclaimer of executory contracts and protection of rights for the holders of property interests. However, none of these proposed reforms appear to be directed towards the unique issues

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[56] An interim receiver does not fall within the definition of "receiver" in the BIA and, as a result, does not trigger the rights provided to unpaid suppliers under section 81.1 of the BIA.

associated with information technology. This is both surprising and disappointing considering the number of insolvencies occurring in the information technology industry in recent years and the economic consequences to industry participants from a continuing climate of uncertainty.

Some insolvency practitioners have suggested that an economic disadvantage arises for Canadian entities as a result of the uncertainties which exist in the Canadian insolvency context in relation to information technology issues, given that many of the corporations in this industry will have contractual dealings with corporations based in the United States. Such U.S. corporations, who are familiar with the far more extensively legislated rights available to them under U.S. bankruptcy law, and in particular Chapter 11 (the U.S. equivalent to the CCAA), are typically astounded to hear of the risks of entering into the Canadian marketplace and placing their information technology within the potential embrace of a Canadian trustee or receiver. It is not too late for the information technology industry to lobby the federal government for specific amendments to insolvency legislation which more properly recognize the growth of technology based business and the unique problems arising for them in the insolvency context.