The Canadian Insolvency System
"A Brief Overview"

1. INTRODUCTION

1.1 Constitutional Background

Canada has a federal system of government. Legislative jurisdiction is divided between the federal legislature (parliament) and the legislatures of Canada's ten (10) provinces.

Bankruptcy and insolvency is a matter of federal jurisdiction. Accordingly, in principle, bankruptcy and insolvency law and practice should be uniform across Canada. However, property and civil rights, which includes the areas of real and personal property and the creation and realization of security, are matters of provincial jurisdiction. Laws in the area of property and civil rights differ from province to province. The juxtaposition of these provincial laws and federal bankruptcy and insolvency laws give rise to some provincial differences in insolvency law and practice notwithstanding the supposed uniformity.

Moreover, the Courts having jurisdiction in bankruptcy and insolvency matters across Canada are the provincially-administered Courts of general jurisdiction which are staffed by federally-appointed Judges. Judges are appointed to exercise general jurisdiction within a province; there are no "bankruptcy Judges", although the Courts of some of the provinces have organized themselves in such a way as to promote specialization of Judges. There is some variance from province to province in the way the Courts function.

1.2 Statutory Framework

Canada has two (2) main federal statutes dealing with insolvency, namely, the *Bankruptcy and Insolvency Act* ("BIA") and the *Companies' Creditors Arrangement Act* ("CCAA").

The BIA deals both with full bankruptcy (analogous to Chapter 7 of the *U.S. Bankruptcy Code*, but with many differences) and the reorganization of corporations and individuals.

The CCAA deals with the reorganization of corporations or corporate groups having aggregate liabilities of at least CDN$5,000,000. This statute is Canada's closest equivalent to Chapter 11 of the *U.S. Bankruptcy Code*, but there are great differences in the law, the practice and, to some extent, the policy of the law.

The reorganization system provided by the BIA is rather rigid. It provides a relatively quick, simple and inexpensive system of reorganization, but it lacks the flexibility usually required for the reorganization of larger enterprises. Typically, it is used for the reorganization of small and medium size businesses. Reorganizations of large entities are usually conducted through the CCAA process.

1.3 **The Canadian Psyche: Differences between Canadian and U.S. law and practice**

The differences between Canadian and U.S. law and practices cannot be understood merely by way of a comparison of the differences in the respective statutes. In addition to those, there are significant systemic and cultural differences.

The Canadian process tends to be less litigious. Litigation plays a much smaller role in Canada than is the case in the U.S. Our bankruptcy system is more business-driven. Accountants have a much bigger role in the process than in the U.S. where attorneys drive the process to a greater extent.

Negotiation among stakeholders plays a major role. In reorganizations under the BIA, the Courts frequently have a negligible role. In CCAA proceedings, where the Courts have a greater role, there is a tendency on their part to encourage negotiation.

Canada has a system of federally-licensed bankruptcy trustees. Trustees are professionals who are usually chartered accountants (the Canadian equivalent of CPAs). The major accounting firms all have bankruptcy and restructuring departments headed by bankruptcy trustees. These trustees are important figures in any Canadian insolvency proceedings.

1.4 **General Overview**

The present outline is not intended as an exhaustive analysis of the Canadian Insolvency System. It seeks only to summarize the salient features of the system and to provide a glimpse of the context and dynamics of the system.

2. BANKRUPTCY (CHAPTER 7 EQUIVALENT)

The term “Bankrupt” in Canada applies only to the situation where the debtor’s assets have vested in a bankruptcy trustee for the purpose of liquidation. A reorganizing debtor is not referred to as a “bankrupt” or as having gone into bankruptcy, although the process of reorganization is sometimes referred to as being “under bankruptcy protection”.

A debtor is adjudged bankrupt by:

(a) the issuance of a “Receiving Order” by the Court upon the petition of one (1) or more creditors of the debtor having uncontested claims of CDN$1,000; or

(b) the debtor having filed an assignment of its assets for the benefit of its creditors; or

(c) a debtor having initiated the process of reorganization under the BIA without such process having resulted in an accepted and judicially approved “Proposal” or Plan.

In each case, the assets of the debtor are vested in a bankruptcy trustee who proceeds to the liquidation of the assets and, if appropriate, an investigation into the affairs of the debtor.

When the bankruptcy results from proceedings instituted by creditors, the bankruptcy trustee is appointed by the Court, but is invariably the trustee proposed by the petitioning creditors. When bankruptcy results pursuant to proceedings instituted by the debtor (assignment for the benefit of the creditors, or a failed BIA reorganization attempt), as a practical matter, the trustee is the party designated by the debtor. There are provisions for the change of Trustees, but they are seldom used.

At a meeting of creditors which takes place shortly after the debtor becomes bankrupt, the creditors may appoint a group of up to five (5) individuals known as "Inspectors" to work with, and supervise the Trustee. They are, in effect, a Creditors' Committee.

The BIA has a detailed system of administration of claims. Creditors are notified to file their claims, the claims are either accepted or rejected by the Trustee. If rejected, the creditors have a right of appeal to the Court.

3. REORGANIZATION UNDER THE BIA

The BIA provides for a system of reorganization which is initiated by a debtor filing either a "Proposal" or a "Notice of Intention to File a Proposal" ("NOI"). Proposal is the term used in the BIA for a plan of compromise.

The filing of an NOI brings with it an automatic stay of proceedings in favour of the debtor for an initial period of thirty (30) days. It is susceptible of successive renewals for periods not exceeding forty-five (45) days, with a statutory maximum stay period, preceding the filing of a Proposal, of six (6) months. The filing of a Proposal also gives rise to an automatic stay.

A Proposal must be filed during the stay period following the filing of an NOI failing which the debtor becomes automatically bankrupt.

The BIA does not contemplate the renunciation of executory contracts other than commercial leases of premises. With that exception, it contemplates solely the compromise of debt.

A Proposal must be accepted by two-thirds (2/3) of the creditors of every class in dollar value and a majority in number. Typically, there is only one (1) class of creditor to which a Proposal is directed, namely, ordinary unsecured creditors. Secured creditors are usually dealt with by individual negotiation under the BIA since there are seldom groupings of secured creditors susceptible of being put together into a class for voting purposes.

A trustee, who must be a licensed bankruptcy trustee, is named by the debtor under the NOI and under the Proposal. The trustee acts as a monitor, reports to the Court under certain circumstances, and frequently serves as a go-between among the different stakeholders. While the statutorily-mandated role of the trustee in Proposal proceedings is rather limited, the practice is that the trustee performs a crucial role and is often the focal point of the proceedings.

Creditors are called upon to file claims as soon as the Proposal has been filed. The process of dealing with the claims is similar to that which applies in the case of bankruptcy, except that the debtor plays an important part in the acceptance or rejection of claims. Creditors may appeal the rejection of claims to the Court.

The BIA provides that a meeting of creditors must take place within approximately three (3) weeks following the filing of a Proposal. There is provision for the adjournment of a creditors' meeting. If the Proposal is accepted by the required majority of creditors at the meeting, the Proposal is submitted to the Court for approval. Typically, the Court-approval process is a formality; it is seldom contested.

If the creditors fail to accept the Proposal, or if such acceptance occurs but the Court fails to approve the Proposal, the debtor is deemed to be bankrupt. In the case of a bankruptcy following the failure of the creditors to accept the Proposal, the meeting at which the negative vote took place is transformed into a meeting of creditors under bankruptcy, and the bankruptcy process proceeds.

4. REORGANIZATION UNDER THE CCAA

4.1 Introduction

The CCAA was enacted in the 1930s, at the time of the great depression, as a mechanism to provide relief for insolvent corporations. The statute fell out of use, and was almost totally ignored until about the early 1980s. Since that time, it has been used as the statute of choice for the reorganization of large insolvent corporations.

The CCAA is a very short statute. It was somewhat modernized and extended by two (2) sets of amendments in the 1990s, and it is presently undergoing the process of governmental review which will probably give rise to substantial amendments within the next few years.

The main features of the CCAA are the following:

(a) It is available to corporations or groups of corporations having debts totalling at least CDN$5,000,000;

(b) It provides for the possibility of a judicially-granted stay of proceedings for an initial period of thirty (30) days with the possibility of judicially-granted extensions, on notice to creditors, for unlimited periods and in unlimited numbers;

(c) It provides for the reorganizing debtors to file a plan of arrangement which, in order to be binding, must be accepted by the respective classes of creditors by a two-thirds (2/3) majority in dollar value and a majority in number;

(d) It provides for the appointment of a Monitor to monitor the affairs of the debtor, report to the Court, report to creditors and to provide such other functions as are judicially mandated.

The statute is very sparse, and its text provides very little enlightenment on how the system actually works.

In practice, the Courts, essentially through the exercise of their inherent jurisdiction, have greatly expanded the scope of the CCAA, and have crafted what is, in effect, a customary regime of reorganization of large insolvent corporations.

The position taken by Courts on various aspects of reorganization under the CCAA vary greatly from province to province. This gives rise to a significant amount of forum shopping, which has been facilitated by a very flexible interpretation of the provisions of the CCAA dealing with geographical jurisdiction. In this regard, the Courts of the Province of Ontario are seen as being very efficient and receptive to the CCAA process and to the creative solutions proposed thereunder. Accordingly, many of the most important restructurings under the CCAA take place in Ontario without regard to where the "center of gravity" of the reorganizing corporation is located.

4.2 **Certain Features of the CCAA**

The following is a description of certain features of the practice which has evolved under the CCAA:

(a) **Stay of Proceedings**

The CCAA provides very little guidance as to the form or substance of the stay of proceedings, other than to provide limitations in certain closely defined areas. For example, the CCAA precludes an Order for the obligatory extension of credit, an Order preventing the closing out of a widely defined category of "Eligible Financial Contracts", or an Order precluding the drawing on a letter of credit.

Stay Orders under the CCAA are as complex as the stability provisions of the CCAA concerning the stay are simple. Over the years, stay Orders have become more and more voluminous, sometimes extending to between 50 and 100 pages.

Such Orders typically extend well beyond the bounds of a temporal suspension of proceedings into the realm of substance. For example, although the CCAA has no provisions whatsoever relating to executory contracts, stay Orders, virtually as a matter of routine, give the debtor the unfettered right to renounce executory contracts, as and when it sees fit throughout the course of the proceedings, subject to the consequence of the renunciation (i.e., damages) being dealt with as part of the plan to be filed in due course. There is no necessity for a debtor to adopt executory contracts; they remain in force unless otherwise affected by an Order or by an action taken pursuant to an Order.

CCAA stay Orders sometimes extend to the relationships between third parties. For example, there have been instances wherein it has been ordered that fellow shopping center tenants of a reorganizing retailer were prohibited from exercising recourses against their landlord which would otherwise have been triggered by the debtor's renunciation of a lease in a shopping center.

As a result of the far-reaching scope of stay Orders, the course of the reorganization is very often set, without significant creditor input, well before a plan is filed.

(b) **Debtor in Possession Financing**

The CCAA does not deal with debtor in possession financing. The general principle in Canadian reorganization law (whether under the CCAA or the BIA) is that the corporation continues. No new “estate” is created by the filing. The debtor remains subject to the same security interests as before the filing. Accordingly, for example, if the issue is not addressed in an Order, an existing secured lending arrangement can continue.

There are no statutory provisions concerning the priming of existing lenders.

Over the past several years, the Canadian Courts, through the exercise of their inherent jurisdiction, have developed the practice of addressing, and approving, debtor in possession financing, including, in a few, but not in many, cases, the priming of existing lenders. At present, there is no clearly-defined concept analogous to the U.S. “adequate protection” concept.

(c) **The Monitor**

The role of the Monitor, as set out by the statute, is rather limited. In practice, however, the role of the Monitor is extremely important.

Stay Orders frequently create a substantially expanded role for the Monitor which includes the approval of certain contracts, transactions and renunciation of contracts. The Monitor has assumed the role of the “eyes and ears of the Court”. Monitors are usually licensed bankruptcy trustees, although the CCAA does not so require, and they are frequently members of large, highly respected, accountancy firms. They usually enjoy a high level of confidence from the Courts and other stakeholders. The Courts tend to be very closely guided by their views and reports. The result is that Monitors have become a major factor in the reorganization process.

(d) **Creditors’ Committees**

The CCAA does not address Creditors’ Committees. CCAA proceedings are frequently conducted without any formal involvement of representatives of creditors, with the result that the first appearance of creditors is at the meeting of creditors called upon to vote on the plan, whose direction has already been determined.

Occasionally, the Court orders the formation of a Creditors’ Committee to receive information and to interface with the debtor and/or the Monitor in the formulation of a plan.

(e) **Claims’ Process**

The CCAA does not address the process of the filing and administration of claims. The process is usually set through an Order of the Court.

Sometimes the process set out in the BIA is adopted. Otherwise, the debtor proposes a claims process which allows for a quick determination of the value of claims for voting purposes and, if necessary, a more in-depth process of determination for distribution purposes. The Monitor is usually given an important role in the process. However, the process always provides for the possibility of a judicial determination.

(f) **Classes of Creditors**

Different classes of creditors vote separately. It is left to the debtor to propose the classification of creditors as part of the Plan. There has evolved a principle of "commonality of interest".

Because a Plan must be accepted, separately, by each class of creditors to which a compromise is offered there is a tendency on the part of debtors to attempt to limit the number of classes as much as possible so as to restrict the influence of any small group. Although the debtors' proposed classification is subject to contestation before the Court, Courts tend to be reluctant to order a reclassification which will reduce the chances for the acceptance of a plan.

5. COMMENTS ON SALES OF ASSETS

There is no statutorily-mandated system for the sales of assets whether in bankruptcy or under BIA or CCAA reorganizations.

In bankruptcy, sales of assets are subject to the approval of the Inspectors. Sales usually take place pursuant to a call for public tender or other mechanism designed to obtain the best price. It is only by exception that the Court becomes involved in the process.

Assets are frequently sold as part of the process of reorganization under the BIA or under the CCAA. If a sale is to take place while the process is ongoing, Court authority is generally sought. In the case of the CCAA, a proposed sale is dealt with either in the Initial Order or a subsequent Order. There are no rules as to the sale procedure to be followed. The Court frequently relies upon a report of the Monitor to satisfy itself as to the fairness and validity of the process.

Mendelsohn
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