The Starcom Restructuring - A Consolidated Cross-Border Transaction

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Background

The Starcom Group consists of a publicly traded Canadian parent company and two subsidiary companies, one registered in British Columbia and the other in the State of Washington. The primary asset of the Group was a 48-strand fibre optic line between Vancouver and Seattle which held a monopoly on all of the telecommunications traffic between those two cities. The Group's business consisted of providing telecommunication facilities for cross-border traffic related to voice, data and video communications as well as internet services.

The Group collectively sought relief under the CCAA in January of 1998 at which time the U.S. subsidiary concurrently filed for relief under Chapter 11, although the U.S. proceedings were then stayed while proceedings continued in Canada.

At the time of the filing, the Starcom Group had unsecured creditors totalling approximately $5m U.S. (roughly equally divided between U.S. and Canada) and one dominating secured creditor, AT&T Telecommunications owed in excess of $35m U.S.

The CCAA proceedings were acrimonious, primarily because AT&T took the position at the outset that the restructuring was doomed to fail and attempted to place the Group into bankruptcy. Notwithstanding AT&T's opposition, Madame Justice Saunders of the British Columbia Supreme Court granted an initial stay of proceedings to the Group of six months which was extended at several points in order to permit the restructuring effort contemplated by the Group. The initial concept was that a new financing or a joint venture partner would be obtained to take out AT&T and allow the Group's operations to continue.

Unfortunately, the Group was unable to obtain alternate financing or a joint venture partner and in August of 1998 at the instance of AT&T, William Drake (a former partner of Ernst & Young) was appointed Chief Restructuring Officer and Ernst & Young, Inc. was substituted as monitor. Ultimately, a plan of restructuring was presented by the CRO which contemplated a liquidation of the assets of the two subsidiary companies by selling some of the individual strands in the fibre optic line to purchasers in the telecommunications industry (BC Telephone, Teleglobe and PSI Net) and the balance of the assets of the two subsidiary companies to MetroNet Communications. Despite significant opposition from several creditors and the Group's directors and officers, this plan was eventually approved by the Court for presentation to creditors who ultimately approved the plan in significant numbers. The MetroNet transaction which formed the basis for the plan was completed in January of this year and implementation of the plan by payment to creditors is ongoing.

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Significant Issues

This restructuring was the first instance in British Columbia where a CRO had been appointed. Madame Justice Saunders was somewhat troubled by the concept and expressed concern on several occasions as to the perceived conflict between the role of the CRO (who became the main proponent of the plan) and that of the monitor, where the CRO was the agent of the monitor (who in British Columbia practice is expected to be neutral and express no opinion on the merits of the plan itself). It may be difficult in future BC CCAA scenarios to persuade a BC court to appoint a CRO who is an employee of, or acts as the agent of, a monitor, and notwithstanding the potential for duplication of costs, a separation between the CRO and the monitor will likely be required.

The restructuring plan itself was also of note since it was, in the end, a liquidation plan which some creditors argued should have been accomplished within the context of a bankruptcy rather than a CCAA proceeding.

The more interesting issues, however, related to the cross-border aspects of the case both in relation to the process ultimately adopted and the terms of the plan itself.

Cross-Border Structure

Our firm was appointed to act for the monitor and CRO when they were appointed in August. It quickly became apparent that a liquidation of the assets was inevitable, and that time pressures required an early solution. In looking at the cross-border aspects of the case, it was equally clear that it was impossible to divide the assets between the two jurisdictions for purposes of either sale or treatment of creditors and therefore the usual structure of two independent processes and two independent plans was not viable. This dilemma resulted from the nature of the primary asset (ie. the fibre optic line) since it straddled the border and could not realistically be sold or valued independently. Further, the operations of the two subsidiaries were so closely intertwined that any attempt to separate them for purposes of dealing with creditors and customers independently was essentially impossible.

We therefore decided to select the Canadian forum as the primary focus of the restructuring and to present a single restructuring plan for both of the subsidiary companies on a completely consolidated, cross-border basis.

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To achieve that result, the Chapter 11 proceedings commenced in the name of the U.S. subsidiary were abandoned, and replaced with a filing by the CRO for ancillary relief under section 304 of the U.S. Bankruptcy Code in the names of each of the three companies.

We did not attempt to develop a negotiated protocol as between the Canadian and U.S. courts as increasingly occurs in cross-border scenarios. Our failure to do so resulted primarily from the time exigencies of the case which dictated a more direct approach. Instead, we effectively achieved a court ordered protocol on the basis of the orders obtained in the U.S. proceedings. Two significant orders were obtained. The first consolidated the three section 304 proceedings and significantly abridged the time frames for notice to U.S. creditors in order to enable a more definitive order to be obtained prior to the creditor meetings to approve the plan. The second order (Schedule "A") granted a U.S. stay order, but in all other significant respects confirmed the primacy of the Canadian proceedings. It is interesting to note that the second order directed U.S. creditors to comply with the Canadian CCAA proceedings in all respects in relation to the terms of the plan, service to creditors, and treatment of creditors under the plan and anticipated many of the terms which ultimately appeared in the Canadian sanction order at a time when the plan had not yet been voted upon by the Canadian creditors. This was a significant achievement by U.S. counsel.

In fact, none of the foregoing could have been achieved without the cooperative efforts of a number of the members of the Seattle Insolvency Bar and in particular the efficient administration of the case by Judge Karen Overstreet, the Seattle bankruptcy judge who handled the U.S. proceedings and who was prepared to permit a creative use of the ancillary proceedings provisions under section 304 of the U.S. Bankruptcy Code.

The Cross-Border Plan

Although a liquidation plan, the plan of arrangement ultimately approved by the Court presented several jurisdictional problems, given that it pooled all of the U.S. and Canadian assets and creditors.

The basic concept in the plan was to create two creditor pools; one for general creditors who would share a "basket" of $500,000 U.S., and the second to pay to executory contract creditors the full amounts of their claims. The balance of the monies received from the various transactions all went to AT&T on account of their security. Although AT&T ultimately experienced a shortfall in their security of almost $10m Cdn., they were nevertheless prepared to give up some of the sales proceeds from the MetroNet transaction for the benefit of unsecured creditors. It was also of note that a secured creditor with

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priority after AT&T was relegated under the plan to the general creditor class on the basis that its security had zero value in a liquidation context, and Madame Justice Saunders ratified that form of classification over the strenuous objections of the affected secured creditor.

Because the liquidation involved the continuation of the business in the hands of MetroNet, confirmation of the existing executory contracts was essential. It was also apparent that the potential tax obligations of the Group were uncertain and could not be paid in full if a plan was to succeed. In those circumstances, it became apparent that two significant differences between U.S. and Canadian bankruptcy law presented potential obstacles to the plan and the preservation of the business.

The first difficulty resulted from section 365 of the U.S. Bankruptcy Code which requires that an executory contract creditor be paid the full amount of its arrears if its contract is to be carried forward after the conclusion of the restructuring. In Canada, on the other hand, it is clearly possible for a Canadian court to sanction a plan where executory contracts are confirmed even though default amounts owing under such executory contracts are compromised. Such a plan is apparently not permissible in the United States.

In addition, U.S. bankruptcy law provides for priority for the U.S. Internal Revenue over unsecured creditors whereas the Canadian system now treats most Crown claims as general creditor claims having no specific priority.

The plan which was ultimately filed and approved by the Court compromised on both these points by adopting the U.S. position in relation to executory contracts (all arrears were paid in full) but the Canadian position in relation to tax claims (all tax claims were compromised). Both issues became highlighted at the time of the court application to obtain the second U.S. order since a U.S. executory creditor strongly opposed the transfer of control of the proceedings to the Canadian courts (feeling that its full rights under section 365 could not properly be protected under the Canadian scenario) and a U.S. tax creditor objected to the treatment of the U.S. tax claims. In the end, only the position of the executory creditor was argued in court (given some financial arrangements entered into outside of the court proceedings), but the U.S. court did address both issues at the time of the second order concluding that it did have the authority to allow all proceedings to be carried forward in Canada notwithstanding the content of the plan. Judge Overstreet essentially concluded that section 304 of the U.S. Bankruptcy Code only required "substantial" compliance rather than exact compliance with the principles of U.S. bankruptcy law.

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The approved plan is a useful precedent for a cross-border consolidation as well as an example of a U.S. court recognizing a Canadian CRO and a CCAA proceeding under the ancillary provisions of section 304 of the U.S. Bankruptcy Code, even where the restructuring directly affects a significant number of U.S. assets and creditors in a manner which may be somewhat different from what would ordinarily be required in the context of a purely U.S. restructuring.

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