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**PLAN IMPLEMENTATION AND CLAIMS PROCESSES**

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**1. INTRODUCTION**

This paper discusses how a debtor deals with plan implementation and the claims process in Canada.

By way of overview, Canada has three main insolvency statutes, the *Bankruptcy and Insolvency Act* (“BIA”), the *Companies’ Creditors Arrangement Act* (“CCAA”) and the *Winding up and Restructuring Act*. This paper does not deal with the *Winding Up and Restructuring Act*; it is relatively infrequently used.

The CCAA came into being in 1933 but was not used extensively until a decade ago. It provides great flexibility and has become the most popular piece of legislation for restructuring of large commercial enterprises.

While any corporation can seek restructuring under the BIA, the CCAA applies only to corporations, or corporate groups, involving more than CDN\$5 million in debt (approximately US\$3 million). The CCAA requires significant court involvement. It allows for the exercise of considerable judicial discretion especially with respect to the

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areas of staying proceedings and disclaiming contracts. The benefits arising from great flexibility are somewhat counterbalanced by the negative effect of a lack of predictability.

A BIA plan is largely driven by the statute. There are significant statutory limitations to what can be done under the BIA, and more rigid timelines to be observed. In certain cases, especially in smaller reorganizations, the BIA offers a considerably less costly and more efficient process.

As noted above, most major commercial restructurings now proceed under the CCAA.

As is the case with the U.S., Canada is a federal country. Bankruptcy and insolvency are areas of federal jurisdiction while most commercial relationships, and issues relating to real and personal property security, are of provincial jurisdiction. Notwithstanding that they are of federal jurisdiction, bankruptcy and insolvency matters are dealt with in provincially organized courts. As a result of these factors, there are significant differences in the way insolvency matters are dealt with, both procedurally, and to some extent substantively, and in which the laws are interpreted, in the different provinces.

There are significant differences between Canadian and U.S. law and practice. Some of the main differences are the following:

- (a) The Canadian system is more creditor-orientated than the U.S. model. U.S. lenders are amazed, when operating in Canada, as to how quickly and efficiently they can get control of a distressed situation and, for the most part, “call the shots”. This is in contrast to the “give the debtor another

chance” concept of Chapter 11. The view from Canada is that the U.S. process gives incumbent management too much say in the restructuring process leading to further loss of value to creditors. However, as the use of the CCAA widens, and the orders sought and issued thereunder become bolder, this distinction between the Canadian and U.S. systems is diminishing.

- (b) The Canadian process tends to be less litigious. Part of the reason is cultural. Litigation tends to play 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.
- (c) In all filings in Canada there is a third party monitor appointed by the Court on application of the debtor under the CCAA, and a trustee appointed by the debtor under the BIA. The monitor or trustee is usually an accounting firm federally licensed to serve as a bankruptcy trustee. The primary role of this monitor or trustee is to oversee the conduct of the debtor and to provide information to creditors. In some restructurings this role is significantly enhanced to the point where the monitor or trustee becomes the “ringmaster” of the whole process.
- (d) There is no “cram-down” under which a class which is clearly “out of the money” is denied a say in the proceedings. In Canada, both under the CCAA and the BIA, each creditor class gets to vote and can defeat a plan,

and this, even when the class is out of the money. This creates leverage for such a class which is sometimes inappropriate.

- (e) The bankruptcy legislation does not provide for the restructuring of the share capital of a reorganizing company. This too has the effect of creating leverage for stakeholders who would otherwise be out of the money.

In general, the Canadian process tends to be more consultative with results obtained through negotiations as compared to the U.S. model which involves much longer timelines and many more court appearances.

## **2. RESTRUCTURING UNDER THE CCAA**

### **2.1 The Initiation of the Proceedings**

The first step in invoking the CCAA is for the debtor company to make an application to the court for an order declaring that the debtor company is a company to which the CCAA applies and protecting the company from its creditors while it formulates its plan. The CCAA applies if the debtor company is incorporated in Canada or if the debtor, wherever incorporated, has assets or does business in Canada, and if the total creditor claims against the debtor company, or the corporate group of which it forms part, exceed CDN\$5 million.

In the initial application, the debtor company generally requests that all proceedings against it be stayed until the filing of a plan and the holding of meetings of the respective

classes of creditors to consider the plan of arrangement. The relief sought, and granted, frequently extends well beyond a pure stay. Initial orders, for example, frequently authorize the renunciation of onerous contracts the performance of various acts which would otherwise be contractually prohibited and the creation of special security interests, for example, to protect directors.

The initial CCAA order remains in force for a period not exceeding thirty (30) days. It is subject to renewal without restriction.

The CCAA permits the Court to lift the stay. CCAA orders typically provide the creditors the right to apply to vary any terms of the initial, or any subsequent, stay order.

## **2.2 Voting**

The CCAA requires that the plan of compromise or arrangement be approved by a majority in number of the creditors (or of each class of creditors) voting, representing two-thirds in value of the claims of the creditors (or of each class of creditors) voting. CCAA plans are usually formulated to require the approval of the plan by all the classes of creditors affected by the plan, thereby giving any one class of creditors the right to veto any proposed arrangement in its entirety. It is possible, however, to structure the plan so that it will be binding only on the approving classes, even if other classes do not approve the plan. In most situations, however, this latter possibility has no practical significance. For example, if an out of the money class defeats the proposal, and the plan is not binding on it, it is unlikely that the debtor will be viable.

Classification of creditors in a CCAA proceeding is of critical importance. The more classes of creditors there are, the more difficult it is for the debtor to obtain creditor approval. The CCAA does not contain specific rules on how to determine the appropriate creditor classification; however, guidelines have been established by the courts over the years. The debtor generally proposes the various classes of creditors as part of the plan. The creditors affected have the right to challenge the debtor's classification. Courts have generally accorded debtors wide latitude in formulating classes so as to reduce the possibility of a negative vote.

Once approved by the creditors, the plan must be sanctioned by the court. The court has a duty to ascertain not only that all "legal" requirements of the CCAA have been satisfied, but also that the creditors have acted on sufficient information, with time to consider the plan, and that the plan is fair and reasonable. Once approved, the plan is binding on all the creditors in accordance with its terms.

Unlike the BIA, a negative vote on a CCAA plan does not technically render the debtor bankrupt. As a practical matter, the defeat of a CCAA plan almost inevitably leads to full bankruptcy analogous to a bankruptcy under Chapter 7 of the *U.S. Bankruptcy Code*.

### **2.3 Claims Procedure under the CCAA**

The CCAA contains no elaborate claims procedure. Typically, the claims procedure is proposed by the debtor either as part of the initial application or in a later application. The procedure proposed by the debtor usually deals with such issues as a mechanism for

the acceptance or rejection of claims for voting purposes, the acceptance and rejection of claims for distribution purposes and bar dates for the submission of claims.

The BIA (discussed below) provides a detailed set of procedures for the filing and treatment of claims. The BIA process often serves as a template for the CCAA process.

### **3. PROPOSALS UNDER THE BIA**

#### **3.1 The Initiation of the Proceedings**

Part III of the BIA contains provisions allowing a debtor to make a proposal (plan of arrangement) to its creditors.

A trustee is appointed at the time of a filing. The trustee has a supervisory role over the process but does not operate the business or take possession of premises.

A proposal must be made to all unsecured creditors and may also be made to secured creditors. To initiate the proposal process, the insolvent company either files a Notice of Intention to Make a Proposal (“NOI”) or files the proposal itself. The filing of a NOI automatically results in an initial thirty-day stay of proceedings against all creditors (including secured creditors except in specified circumstances which include a contemporaneous waiver of the stay by the debtor), without the necessity of a court order. During this time, the debtor continues to operate its business and negotiate with its creditors in order to prepare a proposal acceptable to all parties. In addition, during the stay period, no person is permitted to terminate, amend or accelerate any payment under any contract with the debtor by reason only that the debtor is insolvent or has filed a NOI.

No provision of a security agreement that provides that the debtor ceases to have rights to use or deal with the collateral on the debtor's insolvency, default or filing of a NOI is enforceable until the proposal process fails or the proposal is performed. The stay does not oblige any secured creditor, or anyone else, to extend additional credit or to make fresh advances to the debtor.

At the insolvent company's request, extensions to the stay period may be granted by the court in increments of up to 45 days, to a maximum of five months after the initial 30-day resulting in a maximum stay period of 6 months.

### **3.2 Voting**

Creditors vote by class on the proposal. Specific guidelines for the classification of secured creditors are contained in the BIA. Under the BIA, as with the CCAA, each class of unsecured creditor must vote in favour of the proposal by a majority in number and two-thirds in value, for the proposal to be deemed accepted by the creditors. Dissenting creditors and those creditors who did not vote within a class that accepted the proposal are bound by the proposal. Where a proposal has been accepted by unsecured creditors but a class of secured creditors does not approve the proposal by the statutory majority, the creditors in the secured class are not bound by the proposal and are free to exercise their remedies.

A debtor whose unsecured creditors refuse to approve its proposal is deemed to be bankrupt under the BIA equivalent of Chapter 7 of the *U.S. Bankruptcy Code*.

If the proposal is accepted by the unsecured creditors, the trustee must apply to the court for approval. At this hearing, the court will hear submissions from all interested parties, including any dissenting creditor. The court must refuse to approve the proposal if it is of the opinion that the terms of the proposal are not reasonable or are not calculated to benefit the general body of creditors. If the court refuses to approve the proposal, the debtor is deemed to be bankrupt. In practise, it is unusual that an application for the approval of a proposal is contested, and it is even more unusual for a contestation to succeed except in the face of fraud or evident bad faith.

### **3.3 Claim proving procedures under the BIA**

#### **3.3.1 Claims Provable**

Under the BIA, the claims mechanism is similar for both reorganizations and liquidating bankruptcies. A claim provable in a proposal includes all amounts owing, which arise from an obligation incurred prior to the first date of filing of an NOI or the proposal, even if the amount has not yet fallen due or has not yet been determined. As a general principle, any claim that arises subsequent to the date of the first filing is not a claim provable in the proposal and is not subject to the compromise arising from the acceptance and approval of the proposal.

A contingent claim is one which may or may not become a debt, depending on a future event. An unliquidated claim is one which amount requires investigation beyond mere arithmetical calculation. Contingent and unliquidated claims are valued by the trustee,

who then sends a notice to the affected creditor stating the rationale behind the valuation. The creditor then has 30 days to challenge the trustee's valuation by application to court.

A debt that is not due and payable at the date of the filing but at some time in the future is also a debt provable. However, a discount of 5% per annum from the date the dividend is declared to the date the debt is payable must be deducted in determining the claim provable. Where a proposal subsequently fails, and a full bankruptcy occurs, claims are determined by reference to the date of the actual bankruptcy. Any claims proved under the proposal, less any amounts received by way of distribution during the term of the proposal, become claims under the bankruptcy.

### **3.3.2 Proofs of claim**

The BIA requires that in order to vote at creditor meetings or to receive dividends, a creditor must file a proof of claim in the prescribed form. This form must be strictly adhered to, subject to minor variations as may be required in the circumstances. The proof of claim must refer to, or include, a statement of account containing sufficient details to enable the trustee to determine whether it is a valid claim.

There may not be more than one proof filed in respect of one liability.

Any creditor who has filed a proof of claim may examine the other proofs of claim.

### **3.3.3 Notice to File Claim**

The BIA authorizes (but does not require) the trustee to send a notice to any apparent creditor who has not filed a claim. If the creditor does not file a claim within 30 days

after the mailing of the notice, the trustee may make a distribution without taking into account that creditor's claim. The court may allow a creditor additional time to prove its claim. A taxing authority's time limit to file a claim is extended to 90 days. The failure to file a claim within the specified delay is not a bar to a creditor filing a claim at a later date; if funds remain available for distribution, the late claimant is entitled to a "catch-up".

### **3.3.4 Admission and disallowance of claims**

It is the duty of the trustee under the BIA, in cooperation with the debtor, to analyze all the Proofs of Claim. The trustee has the authority to reject Proofs of Claim. Upon rejection, the claimant has a period of thirty (30) days to appeal to the Court.

### **3.4 Secured Creditors under the BIA**

As indicated above, except in certain specified circumstances including a contemporaneous waiver of the stay by the debtor, the filing of an NOI operates a stay against secured creditors. Since the cooperation of secured creditors, especially secured lenders of current funds, is usually essential to the restructuring process, arrangements are frequently made with those creditors before the filing of an NOI for their continuing support and for the granting by the debtor of a waiver of the stay.

The filing of a proposal itself, whether or not proceeded by the filing of an NOI, does not affect secured creditors unless their claims are sought to be compromised. Proposals rarely seek a compromise of the rights of a secured lender of current funds, since, in most cases, such a creditor forms a class of its own and is therefore not subject to the forced

acceptance of a compromise. Accordingly, secured creditors are seldom stayed beyond the time of the filing of a proposal.

### **3.5 Preferred Claims**

The BIA provides a list of claims, referred to as “preferred claims” which enjoy priority over the general body of creditors. These claims must be paid in full, without compromise, before the remaining unsecured creditors are entitled to the distribution of any funds.

The following summarizes the order of these payments in a corporate situation:

- The costs of administration;
- A governmental levy (on a sliding scale which begins at 5% but is capped, in the case of a proposal, at a maximum of CDN\$62,500);
- Wages to a maximum amount of CDN\$2,000 per employee;
- Municipal taxes not forming a lien against real property;
- Rent outstanding to a landlord for 3 months rent arrears and accelerated rent, if provided for in a lease limited to the realizable value of assets on the leased premises at time of the filing;

In addition to the preferred claims, a limited number of governmental claims enjoy a super priority. The most important of these is employee source deductions which employers have failed to remit.

### **3.6 Postponement of Claims**

The BIA provides for the deferment of the payment of certain claims until payment in full of all other creditors. These include:

- Certain wage claims for related parties;
- Claims arising from non-arms' length transactions unless they are considered, in the opinion of the trustee or the Court, to arise from "proper transactions";
- Claims for loans where the rate of interest varies as a function of profits.

### **3.7 Landlords**

The BIA provides a mechanism for the compromise of accrued claims. It does not, in general, allow for the renunciation of continuing contracts.

By exception, however, the BIA provides a system for the renunciation of commercial leases of real property where the debtor is the tenant. Such renunciations must occur no later than at the time of the filing of a proposal (whether or not such filing follows the filing of an NOI). Landlords may challenge the renunciation before the Court, upon which the Court is called upon to determine whether it is satisfied that the debtor would not be able to make a viable proposal without the disclaimer of all of the disclaimed leases.

The BIA provides for a mechanism for the quantification of the claims of landlords suffering the renunciation of leases. The claims may be included, by the terms of the proposal, as part of the general body of unsecured creditors or as a separate class.

#### **4. CERTAIN CONCLUDING THOUGHTS**

The Canadian insolvency system is difficult for people used to the U.S. system to understand.

While Chapter 11 is characterized by a myriad of elaborate rules and guidelines supported by very extensive case law, the Canadian statutes are sparse and the case law limited.

Reorganizations under the CCAA are facilitated by the great flexibility which the Courts have afforded to the CCAA process. The benefit of this flexibility is somewhat counterbalanced by a lack of predictability which can be frightening, especially to those participants who are not used to the Canadian insolvency system, and by a perception, in certain quarters, of an inordinate bias in favour of entities seeking to reorganize, sometimes to the undue prejudice of certain stakeholders.

In contrast to the CCAA, the BIA provides a much more rigid system which tends to limit its usefulness to those situations where a reorganization can be achieved through the restructuring of existing indebtedness without the necessity of affecting ongoing onerous contractual relationships (except for commercial leases, which are subject to disclaimers). Both statutes lack provisions, or mechanisms, for distinguishing between pure debt as

opposed, for example, to indebtedness arising from a damages award in security-related transactions.

Neither statute has effective provisions preventing the exercise of leverage by classes of creditors and equity holders who are out of the money.

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