

The Basics of Bankruptcy and Insolvency Law

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TYPES OF INSOLVENCY PROCEEDINGS

- Liquidation in Bankruptcy
- Proposals in Bankruptcy involving re-organizations or going concern sales
- Re-organizations and liquidations under the *Companies' Creditors Arrangement Act (CCAA)*
- Receiverships involving liquidations or going-concern sales

RELEVANT LEGISLATION

- *Companies' Creditors Arrangement Act* (“CCAA”) – principal statute for restructuring of large insolvent companies with debts of \$5 M +
- *Bankruptcy and Insolvency Act* (“BIA”) – provides for orderly liquidation and distribution to creditors as well as for re-organizations under its proposal provisions, which are typically used by smaller corporations owing to the CCAA’s higher monetary limit, greater flexibility and less stringent timelines. The BIA also provides for the appointment of receivers.

RELEVANT LEGISLATION (continued)

- *Courts of Justice Act* – provides for the appointment of Receivers, like a BIA Receiver, who can be appointed to manage and control an insolvent company so as to realize on assets for a liquidation or a going-concern sale, among other things
- *Winding-up and Restructuring Act* – provides for the winding up of certain large companies such as financial institutions
- *Wage Earner Protection Program Act (“WEPPA”)* – employees are compensated by a government program to a maximum of approximately \$3,000 which is subrogated to the rights of unpaid employees’ claim against the current assets of a corporation to a maximum of \$2,000 per employee
- *Personal Property Security Act (“PPSA”)* – registry of all security interests in Ontario

CCAA BASICS

- Used to re-organize companies, but increasingly used for liquidations as well
- Great Depression-era legislation in response to a plethora of corporate bankruptcies
- Similar to BIA proposal, but on larger scale
- Debtor-in-possession regime where the company remains in control of the business subject to the supervision of the Monitor and the Court
- Company must be: i) incorporated, have assets, or carry on business, in Canada; ii) indebted to creditors for \$5M+ ; and iii) insolvent or about to become insolvent

COMMENCING CCAA PROCEEDINGS

- Company files application with the Court, which grants a Stay of Proceedings and appoints a Monitor (court officer with duty to all stakeholders)
- Must set out facts and explain why it needs court protection
- Court has a “model order” usually used to start the process (“Initial Order”)

THE INITIAL ORDER

- Initial Order typically provides for such things as:
 - Stay of Proceedings: Stay of all actions against debtor by secured creditors and unsecured creditors, for an initial 30 days, which can be extended by subsequent order
 - Appointment of Monitor typically tasked with overseeing and assisting management, filing reports setting out the status of the corporation and the Monitor's recommendations
 - Authorization to file a plan of arrangement of compromise (a "Plan")
 - Court-ordered Charges which may include:
 - Administration Charge
 - DIP Financing Charge
 - Directors' and Officers' Charge
 - Critical Suppliers' Charge
 - Priority of the Charges

EFFECT OF CCAA PROCEEDING ON STAKEHOLDERS

- The Company commencing proceedings continues in possession but is subject to the oversight of the Monitor and the Court
- Contractual counterparties are bound. Debtor may disclaim contracts with Monitor's consent or leave of the Court
- Suppliers cannot terminate agreements on basis of filing, but may demand cash on delivery or benefit from Critical Suppliers Charge

EFFECT OF CCAA PROCEEDING ON STAKEHOLDERS (continued)

- Landlords may not terminate leases. Debtor may terminate leases
- Employees may be paid their wages and are to be paid certain statutory wage and pension obligations
- Crown Claims for Income Tax, CPP and EI are to be paid

EFFECT OF CCAA PROCEEDING ON STAKEHOLDERS (continued)

- Beneficiaries of Preferences and Transfers at Undervalue are subject to attack
- Directors and Officers often benefit from a Charge but may be removed
- Shareholders' claims for equity are only to be paid if all other claims have first been paid in full

SALE OF ASSETS

- Ordinary course sales permitted
- Also, bulk sales “out of the ordinary course” are usually allowed within certain limits. Sale and vesting orders are used, granting title free and clear of prior encumbrancers with prior encumbrancers given a right to proceeds of sale instead

CLAIMS PROCESS

- Claims Adjudication Process
- Disallowance of Claims
- Claims Bar Date

PLAN OF ARRANGEMENT OR COMPROMISE

- Classification of creditors: “commonality of interest”
- Claims compromised under the Plan, creditors provides with cash, securities or both
- Creditor approval: majority of each class with 2/3 in value
- Court approves plans that are “fair and reasonable”

PLAN OF ARRANGEMENT OR COMPROMISE

- Approved Plan binding on all creditors with compromised claims regardless of their particular vote
- Monitor files certificate with Court confirming Plan implemented and CCAA proceedings ended.
- If Plan rejected, another Plan may be filed
- Notable recent CCAA proceedings: Air Canada, Nortel, Abitibi

WHAT IS BANKRUPTCY?

- A legal proceeding that is available to an “insolvent” person or corporation to cope with a financial crisis
- Purpose: fresh start for individuals and orderly liquidation for corporations
- For an individual, the end result is a discharge from bankruptcy
- For a corporation, the corporation will cease to exist unless all debts are paid in full

SOME STATISTICS ON BANKRUPTCY

- 30 years ago, one in 10,000 Canadians filed for bankruptcy
- In 2006, one in 400 Canadians filed
- Between 1990 to 2011, business bankruptcies declined 68.7%, while consumer bankruptcies, in the same period increased 122%
- June 2012: Consumer bankruptcies were down by 7.0% and business bankruptcies were down by 20.3% over last year

THE *BANKRUPTCY AND INSOLVENCY ACT*

- Federal legislation
- Originally enacted in 1950 with major amendments made in 1992, 1997 and 2009
- Sets out code of law and procedure for bankruptcy
- Supplemented by General Rules and directives issued by Superintendent in Bankruptcy
- More rigid statutory regime with stricter rules and timelines and less flexibility than the CCAA

HOW DO YOU BECOME A BANKRUPT?

Two ways under the BIA:

1. Voluntary: Make an assignment in bankruptcy (s. 49(1))
 - Must owe creditors \$1,000, be a resident of Canada and not already be bankrupt

2. Involuntary:
 - i) Automatic after failed BIA proposal; or
 - ii) A creditor can file an application for a bankruptcy order (s. 43(1))
 - Debtor must owe a debt of \$1,000 and have committed an “act of bankruptcy”

HOW DO YOU BECOME BANKRUPT? (continued)

- Section 42 of the *BIA* lists the “acts of bankruptcy” with the most common being that the debtor has “ceased to meet its obligations generally as they become due.”

WHAT HAPPENS NEXT?

- Trustee appointed
- Debtor's property, subject to secured creditors' rights, vests in the trustee
- Unsecured creditors stayed
- Post-bankruptcy suppliers should revise payment arrangements
- A personal bankrupt cannot serve as a director of a company and must disclose bankruptcy in order to obtain credit
- Trustee sends Notice of First Meeting of Creditors, with proofs of claim

FIRST MEETING OF CREDITORS

- Creditors must file proof of claim to attend (and, later, to receive dividend)
- Trustee reviews claims and allows or disallows (with right of appeal from disallowance)
- Creditor may file property claim where it can be established
- First Meeting convened to appoint inspectors who provide instructions to Trustee

THE RANKING OF CREDITORS – WHO GETS PAID FIRST?

- Creditors are ranked as follows under the BIA:
 1. Trusts and deemed trusts (s. 67)
 2. Creditors with a valid charge on assets of the debtor or a right to repossess certain identifiable property:
 - a) Unpaid suppliers (s. 81.1/81.2)
 - b) Unpaid employees for wage claims (s. 81.3)
 - c) Claims for unpaid pension contributions (s. 81.5)
 - d) Environmental claims (s. 14.06(7))

THE RANKING OF CREDITORS (continued)

3. Secured Creditors (ss. 69.3(2), s. 71(2))
4. Preferred creditors (s. 136(1): Funeral expenses, administrative costs, superintendent's levy, deficiency claims for unpaid wages and secured creditors to an extent...landlords to an extent...)
5. Ordinary unsecured creditors (s. 141) paid out rateably
6. Postponed creditors (ss. 137-140.1) including equity claims

DEBTS THAT SURVIVE BANKRUPTCY

- Bankruptcy discharges unsecured debt only
- Non-dischargeable debts (s. 178(1)) include:
 1. A fine, penalty, restitution order
 2. Damages for intentional bodily harm, sexual assault or wrongful death
 3. Alimony
 4. Child and Spousal support
 5. Fraud
 6. Creditors entitled to receive a dividend but unaware of bankruptcy
 7. Student loans
 8. Interest on the above

HOW MUCH CAN A BANKRUPT KEEP?

- **Certain property is exempt from seizure (applies to the equity in the asset)**
- In Ontario, the following property is exempt from seizure by the Trustee:
 - Clothing of the debtor and his family (not exceeding \$5,650)
 - Household furniture, utensils, equipment, food and fuel that are form a part of the permanent home of the debtor (not exceeding \$11,300)
 - A motor vehicle to value of \$5,650
 - Special provisions for farmers
 - **Example:** a car worth \$5,000 with \$2,000 of secured debt against it has equity of \$3,000. This means that the bankrupt is entitled to keep the equity of \$3,000 and unsecured creditors cannot take this amount as it is less than amount of exemption

WHAT ELSE CAN THE TRUSTEE DO?

- Examine the Bankrupt
- **Transfer at Undervalue (TUV):** s. 96: TUVs are transactions in which no consideration was received by the debtor, or where the consideration received was less than the fair market value given by the debtor
- **Preferences:** Section 95(1): payment or transfer of property made 3 months before (if AL) or one yr (if NAL)
- In addition to its remedies under the BIA, the trustee also may use provincial legislation, including:
 - *Fraudulent Conveyances Act*
 - *Assignments and Preferences Act*

CREDITOR ACTIONS: SECTION 38

- If Trustee refuses or has insufficient funding to commence or continue legal proceedings to recover an asset after being requested to do so, the BIA allows for a process where a creditor or a group of creditors act in place of the Trustee
- The creditor applies to the Court for authorization to commence the proceeding on notice to the Trustee and to the other creditors
- If order granted, creditor takes action in own name
- Can share cost of action with other creditors
- If successful, only recover claim and costs - surplus goes to Estate

OPPOSING A DISCHARGE

- Mostly done by creditors – but the Trustee or the Superintendent may do so as well
- Once receive notice of hearing for discharge, creditor can serve Notice of Opposition

THE ALTERNATIVE: CONSUMER PROPOSAL

- Proposal is a contract between you and your creditors
- If accepted by creditors, debtor pays off only a portion of debts, extends the time to pay off the debt, or some combination of both
- To be acceptable, creditors must be better off under a Proposal than in a bankruptcy
- **Advantages:** stops all legal actions by unsecured creditors
- Allows debtor to avoid bankruptcy
- Faster mechanism

TWO TYPES OF PROPOSALS

- **Consumer Proposal:** available if owe less than \$250,000, excluding a mortgage on the principal residence (Division II proposal)
- **Division I Proposal:** no restriction on the amount a person owes but if majority of creditors do not accept the Proposal, person is **automatically bankrupt**
- Proposal must be approved by 66.6% (2/3) of creditors in dollars and 50% plus one in number and the Proposal must be approved by the Court
- The Court can consider whether a bankrupt could have made a viable Proposal in determining whether to grant a discharge

RECEIVERSHIP

- Secured creditor can appoint “receiver” for the enforcement of its security
- Two options:
 - privately, by a secured creditor in accordance with a security instrument, or
 - by a court order (s. 243 of BIA and s. 101 of the CJA)
- Secured creditor must give prior notice of its intention (10 days or more), unless the debtor consents to an earlier enforcement.
- Goal of receiver is to maximize value for all stakeholders (either sell business as going concern or liquidate assets)
- **Notable receiverships:** Blockbuster

PRIVATELY-APPOINTED RECEIVER

- No need for court approval prior to commencing receivership or prior to the disposition of assets
- Can be more expedited and less costly
- The Receiver owes duties to the appointing creditor, but must act honestly, in good faith, and in a commercially reasonable manner so as to maximize recoveries.
- Not immunized from attack (for e.g. for improvident sales) by creditors in the way that a court-approved process facilitates

COURT-APPOINTED RECEIVER

- Officer of the Court with a duty to all creditors, who takes directions and instructions from the Court and derives its powers from the Appointment Order
- Provisions in the Appointment Order can be made to stabilize the debtor's situation and either preserve the debtor's business or sell it as a going concern. Such Orders often include:
 - Stay of proceedings
 - Continuation of Services
 - Debtor-in-possession (“DIP”) financing
 - Dispensation with PPSA and Mortgages Act Notices
 - Authorization for disposition of assets under a certain value
 - Receiver's charge
 - Provisions specifying the property subject to the appointment, the receiver's powers, including the receiver's borrowing power and ability to hold funds, the duty of others to provide co-operation and assistance to the receiver, and a limitation on environmental liabilities

COURT-APPOINTED RECEIVER

- Bid Process Orders
- Sale Approval and Vesting Out Orders
- Distribution Orders