NORTH AMERICAN CROSS BORDER CASES: THE POSSIBLE IMPACT OF IMPENDING INSOLVENCY REFORM INITIATIVES

Initiatives aimed at amending the restructuring regimes in both Canada and the United States are currently ongoing. Although the eventual result of those initiatives is currently unknown, certain of the changes under consideration illustrate some of the key differences between Canadian and U.S. practice in the restructuring context.

In Canada, most large corporate restructurings are administered under the Companies Creditors Arrangement Act (the “CCAA”); in the United States, Chapter 11 of the Bankruptcy Code is the governing statute. Both statutory regimes are directed to the facilitation of corporate restructurings from a “debtor in possession” perspective, and accordingly are commonly and accurately described as similar statutes in terms of result. Nevertheless, in practice there are some significant differences under the two regimes. Those differences become very noticeable when dealing with a cross border restructuring where filings are required in both jurisdictions.

The most commented upon distinction is based upon the fact that Chapter 11 is a detailed code with very specific statutory requirements, whereas the CCAA is very short and sketchy, with few details -- leaving the application of its substantive rules more to the discretion of the judges appointed in individual cases. Given that difference in approach, it is perhaps surprising that U.S. bankruptcy cases generally appear to follow a more litigious path than a typical CCAA proceeding. One might legitimately question why this would be so, since one would expect the more detailed U.S. statute, coupled with a longer history of decisions from multiple courts (which over time would presumably lead to
consensus on many issues), to create greater certainty and therefore fewer areas of disagreement.

Part of the answer to this apparent conundrum results from the undeniable fact that the Bankruptcy Code requires court applications as a matter of course in situations where a Canadian practitioner might expect them to be unnecessary. For example, in the U.S., but not in Canada, insolvency professionals go through a complicated procedure to confirm their engagement and then have their fees approved on a periodic basis throughout the proceedings. Certainly any practitioner who has had experience with a cross border filing immediately finds that the U.S. process is much more court-centered than is a CCAA proceeding. But is the absence of directed court applications in the Canadian context the only explanation for this difference, or is there something more systemic at work?

In the authors’ view, one very basic element of the CCAA process which is unique to Canada accounts for much of the different climate which seems to prevail north of the border. In Canadian proceedings, although the debtor remains in control of its operations throughout the restructuring process, the court must appoint a “monitor” to oversee the company’s operations during the case. That monitor (who is invariably a licensed trustee in bankruptcy associated with a major accounting firm) is empowered as a court officer to ensure that the debtor company complies with the court’s operational requirements and reports periodically to the company’s creditors as to the status of the restructuring and any significant events or material changes which are relevant to the creditors. In addition to this overall monitoring responsibility, increasingly CCAA judges are using the monitor as a substitute for, or an adjunct of, the court’s supervisory
role in relation to operational issues and disputes which might otherwise require a court appearance. For example, unlike the U.S. system where a restructuring company must seek the court’s approval before rejecting or assuming executory contracts, a Canadian company is usually given the court’s permission at the outset of the case to “downsize” its operations by rejecting unnecessary or economically disadvantageous contracts. It does so not by subsequently applying to court for permission in each instance where rejection of the contract is desired, with notice to the affected parties and hearing before the court; instead the Canadian debtor can simply give notice of rejection to the affected non-debtor contracting parties, subject only to first obtaining the approval of the monitor. Similar approval or intermediary mechanisms are often established for other potentially problematic issues such as validating and paying secured claims, approving asset dispositions (other than sale of the entire business), establishing credit arrangements for suppliers, and numerous other matters. All of this activity tends to keep creditors out of court or, to the extent disputes arise, motivates creditors to negotiate and settle issues rather than have them proceed to court, given both the monitor’s ability to provide an independent assessment of the dispute and the influence which a monitor’s viewpoint usually has when disputes do go before the Canadian courts.

In the U.S., by way of contrast, the only near equivalent to the monitor’s role is that of the unsecured creditors’ committee. (In Canada, creditors’ committees are not required and only rarely are they created by judicial fiat.) The creditors’ committee theoretically could be in many respects like the monitor, serving as a watchdog to protect the interests of the creditors. But the relationship between debtor and committee is often a very adversarial one, resulting in a plethora of disputed applications. In many cases, it
can seem that the committee serves primarily to add a layer of legal fees to the debtor’s costs rather than adding real value to the restructuring itself. And even when the committee itself is cooperative, the statutory framework allows all parties in interest – even disgruntled minor players who have an axe to grind – to object to virtually any application, requiring a hearing and leading to delay and additional expense.\footnote{This structure forces the debtor to document every application completely even if it turns out to be unopposed. The possibility of objections means the debtor must file a complete set of papers each time.}

Given the foregoing dynamic, the Canadian system usually is more efficient than the U.S. system, at least in terms of out of pocket economic cost. The reduced number of court applications (to say nothing of the comparative advantages of spending Canadian rather than U.S. dollars) usually results in a much less expensive restructuring in Canada than in the U.S., even after adding in the additional costs of the monitor and its counsel.

However, there are disadvantages to the Canadian system from a substantive law perspective. Those disadvantages have in several recent larger cross border cases persuaded debtors to avoid the CCAA in favour of the U.S. approach, irrespective of any economic advantages which might otherwise be present. The primary substantive disadvantage is the absence of any “cramdown” right under Canadian law, whereby a subservient class with no real economic stake in the company (such as the shareholders of an insolvent company, to take the most obvious scenario) can be summarily dealt with. In the U.S., a junior class can often be ignored, both for distribution and for voting purposes, when the economics are such that the senior classes are not being paid in full. However, such a subservient class in Canada must be given the right to vote on any plan of restructuring if the debtor’s share structure is to be modified as part of the plan (to
allow the creditors to receive a portion of the equity of the company, in the most common scenario), even where the shares have no economic value. Needless to say, this gives leverage to a group of stakeholders with no true economic interest in the restructuring.

A similar problem occurs in relation to class action claims, a significant problem in many restructurings. This is particularly true with public companies, given the potential dollar impact of these types of claims and the fact that they are not easily quantified at the outset of the filing. In the U.S., equity driven claims such as shareholder class actions can be treated as though they were equity and not debt. In contrast, under the CCAA they must be treated as debt and given treatment equivalent to that of other unsecured creditors. In both the recent Loewen and Philip Services cross border restructurings, this fact alone almost certainly drove the debtors to file plans which were focused almost entirely on the U.S. rather than Canada, and which, at least in the Philip Services case, required Canadian unsecured creditors to participate in the U.S. restructuring to achieve any recovery on their claims. That this was essential from the debtor’s perspective (since the class action claimants were effectively deprived of any remedy under U.S. law), overcame the economic disadvantages to the debtor resulting from the higher cost of a U.S. proceeding, which might have otherwise persuaded the debtor to adopt more of a Canada-based solution. However, the end result arguably disadvantaged both Canadian creditors and the Canadian advisors to the debtors, who lost control of these lucrative engagements to their U.S. counterparts.

Canadian practitioners are not oblivious to these consequences, which (from their perspective) are quite unfortunate. A strong lobby is developing in Canada to incorporate even if the economics do not appear to warrant a perfect job.
some aspects of the U.S. cramdown rule into Canadian insolvency proceedings. The Canadian federal government is currently engaged in a review process, mandated by the last set of amendments to the CCAA and its related statute, the Bankruptcy and Insolvency Act, both passed approximately five years ago. That review is intended to produce a new set of amendments in 2002. Submissions proposing a new cramdown procedure have been made to the federal government by various Canadian insolvency organizations. If that lobby is successful, and cramdown becomes an accepted tool for the Canadian insolvency practitioner, it will be interesting to see how many cross border cases continue to be focused on the U.S. side of the border once there is a substantively level playing field between the two jurisdictions.

Meanwhile, the Bankruptcy Code is also the subject of pending proposals for change. Indeed, it appeared quite likely that a bankruptcy bill would have passed in some form in 2001, but the initial House-Senate conference committee session was scheduled for September 12 – and since September 11 Congress has had more important things to worry about. Despite the delay, at the time of submission of this article passage is still a possibility for this year.

However, unlike in Canada, the U.S. proposals are centered on consumer bankruptcy issues, not on business bankruptcy issues. The proposed consumer provisions, particularly those requiring "means testing" as a condition to a Chapter 7 discharge, have been quite controversial. (Those who do not favour the consumer proposals have been known to refer to the legislation as the Bankruptcy "Reform" Act.) While there are some significant proposed changes to the Bankruptcy Code affecting businesses as well, and business practitioners ignore the new bill at their peril, there is no
wholesale restructuring on the table. Among other things, there is no movement towards adoption of a monitor concept, despite its apparent advantage, as demonstrated in Canada, in reducing the litigious nature of the reorganization process and consequently also reducing the costs of the process.

Nevertheless, there is one major addition proposed in the new legislation which is directly relevant to this article: a proposed new Chapter 15 of the Bankruptcy Code, "Ancillary and Other Cross border Cases," based on the UNCITRAL Model Law on Cross Border Insolvency. The purpose of the new Chapter 15 is to give explicit legislative support for the recent trend in U.S. cross border cases toward coordination of proceedings with those of insolvency courts in other jurisdictions. The substantive rules in new Chapter 15 are not very different from those developed over the last several years by bankruptcy judges dealing with a very short and sketchy existing Section 304 (Cases Ancillary to Foreign Proceedings). The case law and practice are not expected to change very much under the new Chapter 15. Nevertheless, passage will give legislative blessing to the already existing practice, and will send a signal to other countries that the U.S. will cooperate in establishing a framework for rational multinational proceedings.

An amended provision based upon the Model Law is also being considered as a replacement for section 18.6 of the CCAA, the current cross border provision contained in the equivalent Canadian legislation. However, the UNCITRAL Model Law type of provision is perceived by some Canadian commentators as being too inclined to favour the foreign jurisdiction over the domestic jurisdiction, leading to an attempt by some lobbyists to have the amended legislation include the compulsory appointment of Canadian monitors or creditor committees as a condition of endorsement in Canada of
foreign proceedings where Canada is the secondary jurisdiction. This concern stems in large part from an adverse reaction to some of the recent cases decided under section 18.6 of the CCAA, including in particular the decision of the Ontario Supreme Court in Babcock and Wilcox in which a stay order was granted against a solvent Canadian subsidiary of an insolvent U.S. company which had obtained relief under Chapter 11.2

Whatever the eventual result, given the increasing number of cross border cases, and the willingness of courts on both sides of the border to defer to proceedings in the other jurisdiction where it appears to be reasonable and appropriate to do so, substantive differences between the insolvency statutes in Canada and the U.S. will become more and more important. Indeed, there is a risk that forum shopping will rise to a new level as debtors grapple with the various national and international options available to them in the cross border context.

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Under the CCAA, unlike the Bankruptcy Code, it is a condition to relief that the company be insolvent. The Babcock & Wilcox decision appears to have eliminated that requirement from the statute in the context of an ancillary proceeding.