Chartered Accountants of Canada

20 Questions Directors Should Ask about **Insolvency**

WRITTEN BY
Michael E. Barrack and D.J. Miller

20 QUESTIONS

How to use this publication

Each "20 Questions" publication is designed to be a concise, easy-to-read introduction to an issue of importance to directors. The question format reflects the oversight role of directors, which includes asking a lot of questions.

The "answers" or comments that accompany each question summarize current thinking on the issue and practices of not-for-profit governance. If your organization has a different approach, you are encouraged to test it by asking if it provides a valid answer to the question.

Directors coming from a for-profit business may find that their experience, although often helpful, may not always provide the best answers in the not-for-profit environment. The material in this document should help them decide how to adapt their experience to the NPO realm.

Although the questions apply to most organizations, the answers will vary according to the size, complexity and sophistication of each individual organization.

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Chartered Accountants of Canada

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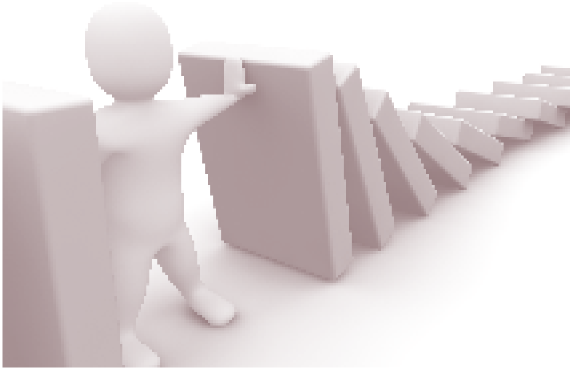

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Preface

The Risk Oversight and Governance Board of the Canadian Institute of Chartered Accountants commissioned this briefing to assist boards in understanding their responsibilities when the companies they serve face an insolvency situation.

Restructuring an insolvent company is a complex and time-consuming undertaking for directors. The more prepared the company and its directors are, the greater the likelihood of a successful restructuring. This publication highlights the issues that directors need to consider, provides an understanding of the potential implications of these issues and offers questions that directors might ask in discharging their responsibilities.

The Risk Oversight and Governance Board acknowledges and thanks the members of the Directors Advisory Group for the invaluable advice, the authors Michael E. Barrack and D.J. Miller and the CICA staff who provided support to the project.

Giles Meikle, FCA
Interim Chair, Risk Oversight and Governance Board

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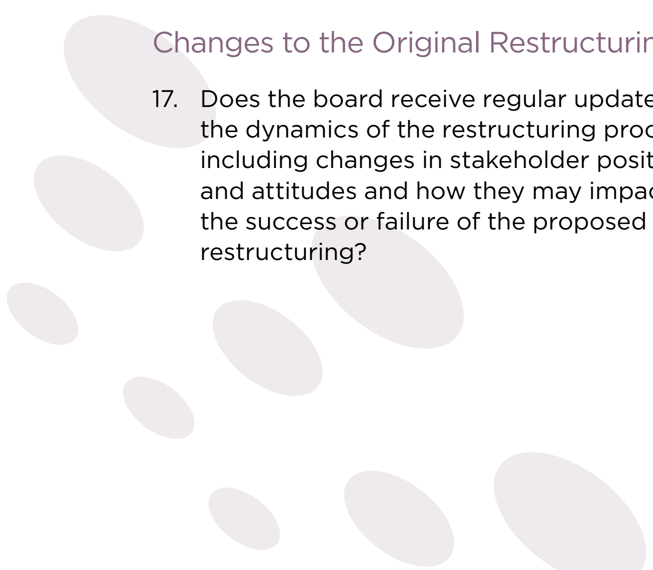
17. Does the board receive regular updates on the dynamics of the restructuring process, including changes in stakeholder positions and attitudes and how they may impact the success or failure of the proposed restructuring?



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Introduction

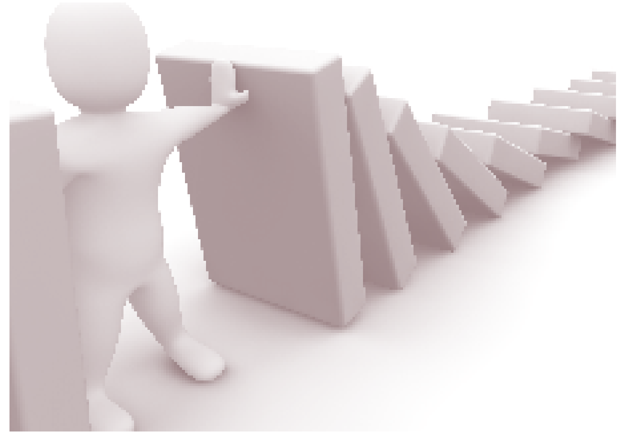
When a company heads into insolvency, the familiar pattern of dialogue and decision-making among the board and management is disrupted. The relative positions of various stakeholders change. Suppliers of goods and capital will have stronger bargaining positions while shareholders, employees and retirees will be in less powerful positions. Highly skilled or experienced employees may leave the company if they are concerned about their continuing employment or competitors lure them away. Regulators, especially in the case of underfunded pension plans, may become more involved in the company's affairs. Customers may grow skeptical about ongoing deliveries or warranty issues and require concessions or assurances.

New players will often become involved in the company. These include professionals whose skills are required for a corporate reorganization, such as insolvency counsel, accountants, investment bankers or a restructuring officer. Sometimes, new directors are asked to join the board for their restructuring expertise, though they may have little industry-specific knowledge. Similarly, management may include new members with restructuring experience but who may also lack familiarity with the industry. The relative power of the board and of the company's management may become diluted.

Meanwhile, there is the potential for complex court proceedings, either as a result of the company filing for protection from its creditors or through proceedings started by someone else.

Directors who are unfamiliar with this environment often find it confusing and frustrating. Board dynamics will change. The time commitment required of directors will increase dramatically. Decisions will be made and events will occur much more quickly. In addition, a normally self-contained board will now find itself constantly interacting with outside advisors.

Decisions that were once straightforward will now have a myriad of stakeholders, each asserting with increasing vigour that the directors should listen to their particular perspective and act accordingly. Some stakeholders (for instance, hedge fund committees) will often attempt to assert outright control over the board and its decisions. Despite this background noise, directors must continue to discharge their duties responsibly by keeping focused on what is in the company's best interests.



This publication addresses these and other issues that face directors when a company may be facing insolvency. It is intended to provide a practical resource to those currently acting as directors, and those who may consider acting as a director in future. A director's understanding of these issues *prior to* any determination of a company's insolvency will help to ensure that the company considers all options available to it, increasing the likelihood of a successful restructuring. Two pounds of prevention and planning are often worth ten pounds of remedy.

Directors' Fiduciary Duty During Insolvency

When a company is close to insolvency it becomes increasingly difficult for directors to discern what is or isn't in the company's best interest. Often, directors will find it impossible to please all stakeholders. There is no principle, however, that one set of interests – for example, those of shareholders – should prevail over another set of interests. Instead, the issue for directors will be whether, in all the circumstances, they made business decisions in good faith with a view to the company's best interest, having regard to all the relevant considerations.

The Supreme Court of Canada addressed the issue of directors' duties and to whom they are owed when the company is insolvent in its ruling in a dispute between BCE Inc. and its debenture

holders. The debenture holders argued that the directors had failed in their duty when they arrived at an arrangement that was acceptable to the now-insolvent business but would prejudice the group of debenture holders.

The Supreme Court made a number of statements about the scope of a director's duty to a company's various stakeholders noting that a director was required to act in the best interests of the company viewed as a good corporate citizen. "Acting in the best interest of the corporation" may obligate directors to consider the impact of their decisions on *all* corporate stakeholders, but directors owe a fiduciary duty to the *corporation*, and only to the corporation. As such, the court held that it was acceptable that a decision that was in the best interests of the company might prejudice an individual stakeholder's position.

The court itemized a list of potential sources of legitimate stakeholder expectations, including:

- general commercial practice;
- the nature of the corporation;
- the relationship between the parties;
- past practice;
- steps that the complaining stakeholder could have taken to protect itself;
- representations and agreements; and
- the fair resolution of conflicting interests between corporate stakeholders.

The ultimate test will be the directors' responsible exercise of business judgment in favour of the company as a good corporate citizen. To do that, the process of exercising that judgment must be explainable and recorded. When a company is insolvent there are fewer realizable assets than there are liabilities, and everyone is therefore a potential target.

Legal Definitions of Insolvency

Canadian legislation contains various tests for determining whether a company is insolvent.

The *Canada Business Corporations Act* ("CBCA") defines a company as insolvent if:

- it is unable to pay its liabilities as they become due; or
- the value of its assets is less than that of its liabilities and stated capital.

The *Bankruptcy and Insolvency Act* (Canada) ("BIA") describes a company as insolvent if:

- it is unable to meet its obligations as they become due;
- it has ceased paying its current obligations in the ordinary course of business; or
- the aggregate value of its property (if sold under legal process) would not be sufficient to pay all of its obligations.

The *Companies' Creditors Arrangement Act* ("CCAA") allows "debtor companies" (i.e., those that are bankrupt or insolvent) to seek protection from creditors while they attempt to restructure. However, since the CCAA contains no definition of *insolvency*, a test has developed from cases decided by the courts under that statute. This test is broader than that set out in the BIA, allowing more companies to seek protection under the CCAA. This is consistent with the rehabilitative policy goals of the CCAA.

Because of the CCAA's rehabilitative aspects, the courts have taken a pragmatic approach in evaluating the solvency of companies seeking protection. For instance, companies do not have to actually run out of cash to qualify as "insolvent" since their financial crisis may be so advanced at that point that they would have insufficient resources to successfully restructure. Companies, therefore, can qualify as insolvent if a looming liquidity crisis means they can be reasonably expected to run out of money before being able to implement a restructuring. (Similarly, such companies could be considered "insolvent" under the CBCA because "liabilities" under that legislation includes any provision for future or contingent liabilities.)

It remains to be seen as to how far in advance of a looming liquidity crisis the company may be, and still be prospectively viewed as insolvent under the CCAA.

Directors should assess these factors, since the choice of which route is the most appropriate for the company is an issue of board judgment.

Part A: Assessing the Corporation's Financial Health

An early determination as to whether a company is, or is likely to become insolvent, is crucial for a number of reasons:

(i) Certain restructuring options are only available to *solvent* companies, such as those under corporate statutes like the CBCA. Other options, such as those under the BIA and the CCAA, require that a company be *insolvent*. Companies also have the option of restructuring under private (out of court) arrangements. Determining early that the company is headed towards insolvency allows it the greatest choice of restructuring options (see Part D).

(ii) Insolvency may trigger a default under various agreements to which the company is a party. Such an event can give the other parties to these agreements additional rights and remedies, such as the right to terminate material contracts, require that security be provided or alter normal payment terms. Although the insolvency of privately held corporations will not generally be known to third parties, public companies are required to disclose financial and other information.

(iii) Restructuring is a complex process and will be most successful when problems are detected early and there is time and opportunity to address its problems before the company's financial situation deteriorates further.

In order to determine a corporation's financial health, directors should strive to answer a few basic questions:

1. **Has the company been able to meet its obligations as they come due? Are there any pending payments the corporation will not be able to meet?**

2. **Is the company stretching ordinary payment terms with suppliers or not meeting any obligations in order to conserve cash?**

3. **Does the company have any registered pension plans? What is the funded status of the pension plans? Is the company current with all required payments and all obligations under relevant pension legislation?**

For directors to determine whether a company is insolvent or at risk of becoming so in future, they must have a detailed understanding of the company's current financial status, budgets and forecasts, and the market in which the company operates.

Often, management may be overly optimistic about assumptions contained in budgets and forecasts, and the company's ability to meet them. Directors, therefore, should be prepared to ask questions until they are satisfied as to the reliability of the financial information, based on their understanding of the business. Additional credibility can be obtained by having an independent third party vet the forecasts. A third party can also be useful in providing input on business or market trends, technology or competitive changes, each of which could significantly impact financial performance and lead to insolvency.

Financial information for directors to consider and discuss with management include:

Financial statements

When auditors are concerned about the company's ability to continue in business as a going concern, a qualification is made to that effect in the financial statements. However, since audited financial statements are prepared for a specific purpose based on historical financial information, financial statements alone may not be adequate to assess a company's solvency.

Historical results

When reviewing financial information with management, directors should consider management's answers in the context of historical results for the same month, quarter or other reporting period since some businesses are seasonal or cyclical within a fiscal year. Comparisons will help determine whether the financial situation relates to the seasonal or cyclical nature of the business, or represents an issue of concern.

Future obligations

Directors should inquire about any significant one-time payments arising in the foreseeable future that could have a material impact on the company's ability to meet its obligations. These may include (i) the maturity of long term debt and inability to secure acceptable alternate refinancing, and (ii) the significant burden arising from amounts required to fund pension deficits or solvency payments under pension legislation. Companies that are able to meet their ordinary obligations, but not their pending significant one-time payments, would be considered insolvent under some statutes.

Contingent liabilities

Directors should also inquire about contingent liabilities that may not appear on a balance sheet. For example, in ongoing litigation where the outcome is uncertain, a potential liability may exist that is impossible to determine. If products have been recalled for health or safety issues and the company is subject to lawsuits, the potential impact of this contingent liability may be greater than other liabilities appearing on its balance sheet.

Pension plan obligations

One issue of considerable concern facing directors of many companies at this time is the means by which the company's pension obligations can be addressed, particularly where the company wears "two hats" as both plan sponsor and administrator of defined benefit pension plans. A recent decision of the Ontario Court of Appeal[1] has created further uncertainty for companies and the directors who serve on their boards as it relates to pension obligations. It is not clear whether that decision, which is currently under appeal to the Supreme Court of Canada, may be limited to the facts of that case, or will apply more generally. The decision calls into question whether a company (and by extension, directors who may sit on a pension committee) can continue to act as administrator of a pension plan once the company is insolvent and seeks formal court protection from its creditors, where the pension plan is one such creditor. The stakes on this issue are high, as the deficits under defined benefit

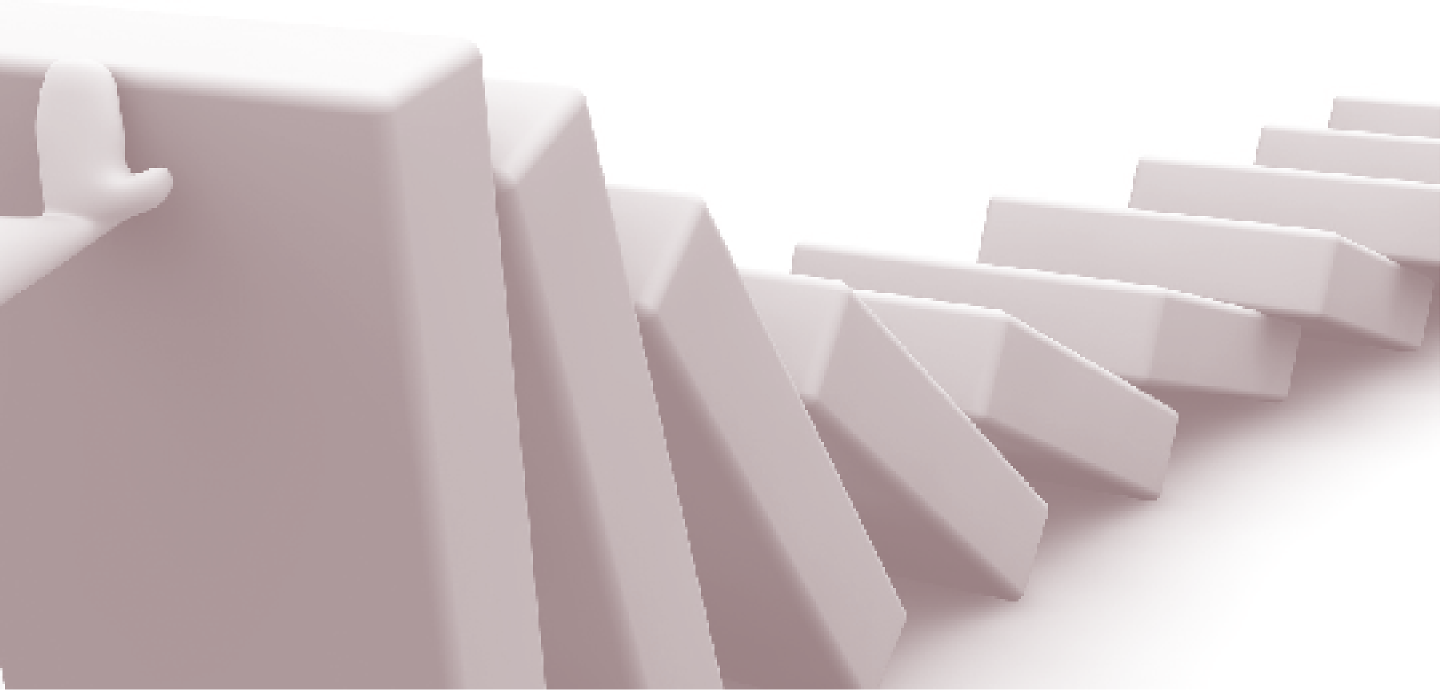
pension plans for many companies represent a very significant liability. Organized stakeholders, such as unions and other employee groups, have become well informed and active in pursuing claims on behalf of those stakeholders. In view of the uncertainty created by the Indalex decision, directors need to ensure that they, and the company, obtain very specific advice on this issue prior to taking any steps to address the company's insolvency.

When questioning management about the company's financial health, directors need to ask the right questions. Simply asking "Is the company insolvent?" will most likely receive a straightforward yes or no response. Asking for specific information may result in more useful information.

Related Corporate Groups

4. **If the company is financially or operationally integrated with others, are any entities within the group solvent on a stand-alone basis? If the corporate group has most of its cash and assets outside Canada, how could that affect the company and a possible restructuring?**

[1] Leave to appeal the *Re Indalex* decision to the Supreme Court of Canada has been sought, but at the time of writing no decision on whether leave would be granted or the appeal would be heard has been issued.



Difficult issues can arise when directors review individual and consolidated financial statements for members of a related corporate group. For example, one entity may be solvent on a stand-alone basis while the group as a whole is not.

Directors need to consider whether an insolvency assessment should be on an individual corporate entity basis or the corporate group as a whole. Many companies are part of a related group of companies, including holding companies, and may be related to companies that operate in various jurisdictions in Canada or elsewhere. Cash may also be “bottled up” in various jurisdictions around the world, and directors should assess where it is and how available it is in determining whether the corporation is insolvent.

Factors to consider when determining if the company operates on a stand-alone basis or is integrated operationally and financially with others include whether:

- financial reporting is done on a consolidated or individual basis;
- centralized banking and financing arrangements exist, perhaps through a centralized cash management system;
- loan facilities are (directly or indirectly) available to and payable by all members of the corporate group;
- financial assistance is provided among the various members of the group, making them financially inter-dependent;
- the operations of the various entities are functionally dependent on one another; and
- head office functions and resources are provided to members of the group rather than on an individual entity basis.

Part B: Impact of Insolvency on Directors

5. **Are the directors prepared to continue on the board, and do they have the time to commit to the additional demands placed on them? If the board needs to recruit new directors, what qualifications should we look for in new director candidates?**

When faced with the company's existing or pending insolvency, the demands on the board's time become much greater than normal. Directors who cannot accommodate the additional time requirements should resign. If directors do resign, the board should consider how it will manage those resignations since stakeholders may perceive a director's resignation to indicate a lack of confidence in the company's ability to restructure. Boards should also consider whether departing directors should be replaced, which can be done by assessing the board's aggregate skill set to determine whether additional expertise is required.

Boards rarely have directors with insolvency-related experience among their existing members and candidates with such experience are often reluctant to join the board of an insolvent company. A potential director with restructuring or industry-specific expertise who is willing to join the board can be a valuable asset. If that occurs, other directors should guard against unduly relying on that director's opinion in place of using their own judgement to fulfil their obligation to act in the best interests of the company. Boards should also consider the effect that changing the board's composition may have on its operating dynamic.

Director Liability

6. **Has the company failed to meet its obligations related to tax withholdings and/or employee wages, or are there other offences that create a potential liability risk for directors?**

When there is insufficient cash to pay all the company's debts, everyone becomes a target including directors. Directors may find themselves wondering whether it is better to resign immediately in order to terminate the period in which they could be exposed to liability, or continue to serve and help navigate the company through a period of insolvency. Some areas for which directors and officers often face personal liability are discussed below, followed by a summary of certain protections that can be available to directors who decide to remain in that capacity:

Source Deductions

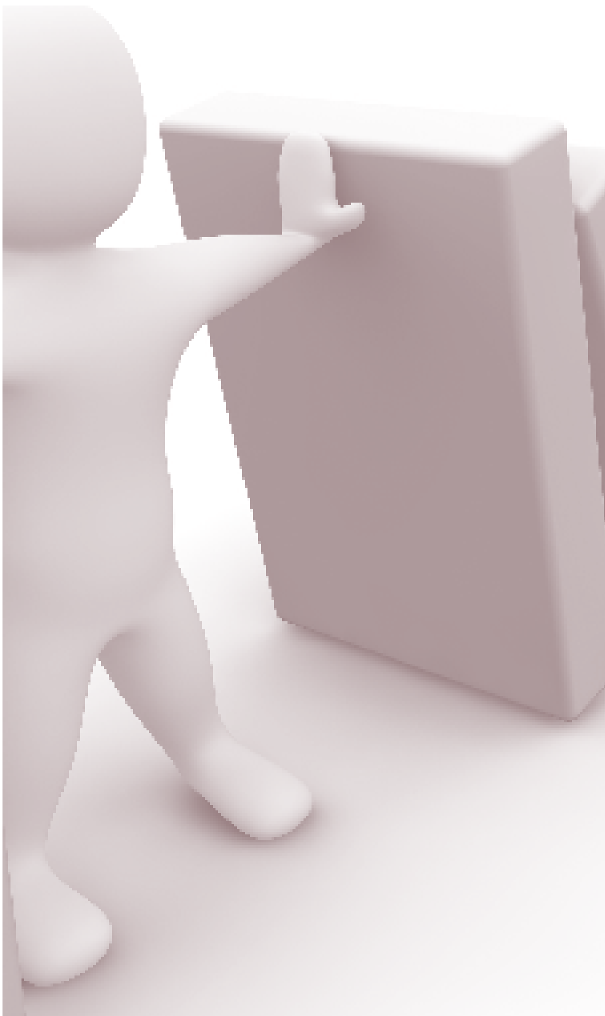
These include unremitted taxes, withholdings for Canada Pension Plan and the employer's premium for Employment Insurance. If the company fails to withhold or remit statutory deductions "at the source" (i.e. from gross payroll) on behalf of its employees, directors serving on the board when the tax liability was incurred may be held personally liable. Honest mistakes and the ability to show that reasonable steps were taken to prevent the non-payment may be offered as a defence.

Wage Liabilities

Directors may be liable for employee claims related to unpaid wages and vacation, termination and severance pay if they cannot be paid out of the company's assets. Under the *Wage Earner Protection Program Act (Canada),* the federal government will pay up to $3,000 per employee for unpaid wages, including severance and termination pay, in a bankruptcy or receivership of the employer company. However, the federal government can then pursue a consolidated claim on behalf of all the affected employees against the company or a director. The liability that directors may be exposed to will depend on the availability of company assets to satisfy employee claims, the province the company is located in and whether a collective bargaining agreement is in place.

Statutory and Regulatory Offences

Directors may be held personally liable for offences related to bankruptcy, such as fraudulently disposing of the bankrupt's property, making false entries in accounting statements, concealing company property or concealing the company's true state of its affairs. Directors may also be held liable for other fraudulent activities and offences. For example, directors are not permitted to declare dividends if the company is insolvent or is likely to become insol-



vent after the dividends are paid. Directors who vote for or agree to such actions are jointly and severally liable for the dividend.

Tort and Other Claims

Directors are normally protected from personal liability for torts committed by the company. In some circumstances, however, the courts will impose personal liability on directors, in particular for environmental torts, trespass, the tort of private nuisance and negligence. For instance, an act or omission that results in the release of a hazardous substance across property boundaries and causes injury or damage can lead to claims in tort. In an insolvency, there is an increased likelihood that transactions will be challenged or claims will be brought to prevent transactions that are perceived to be fraudulent. Insolvency also creates a heightened environment for the advancement of claims for breach of fiduciary duty against directors, as stakeholders often see insurance policies as a more likely source of recovery than the company's assets to be divided amongst its many creditors.

Environmental Liability

Directors may face liability for environmental damage caused by the company during their tenure as directors. Provincial governments have the authority to issue orders concerning clean-up of contaminants that are binding on anyone who directs or manages the contaminating business. Such orders can lead to substantial monetary liability.

Protections for Directors

7. What protections has the company put in place for directors? Are these sufficient or does the board need further protection pursuant to a court order?

The courts recognize that a company's board of directors must be able to dedicate its full energy and attention to resolving the company's problems and developing a plan for its restructuring.

When directors determine that the company is insolvent or at risk of becoming insolvent, they should retain independent counsel to advise them throughout the course of the restructuring. This allows directors to focus on the restructuring and make decisions in the company's best interest, without any undue concerns about the impact their decisions may have on their potential personal liability. Courts have also approved various tools to empower directors to achieve these goals without fear of potentially overwhelming personal liabilities.

Stay of Proceedings

In restructurings under the CCAA and BIA, the court normally orders that all actions against directors be put on hold until a compromise or arrangement is accepted or refused by the company's creditors. A stay of proceedings:

- applies only to actions that arose prior to the CCAA or BIA proceedings and that relate to obligations of the company for which directors are liable;

- allows the parties to consider a compromise or arrangement regarding claims against directors, while encouraging directors to develop a workout strategy for the insolvent company;
- extends to anyone who manages or supervises the business in situations when all the directors have either resigned or been removed by shareholders; and
- does not cover actions against directors for guarantees they may have given for the company's obligations, or actions that seek an injunction against directors forcing them to either do or not do something in relation to the company.

In formal restructuring proceedings, all creditors' claims are filed, reviewed and accepted or disallowed for the purposes of voting on the restructuring plan and any distribution under the plan. Claims against the company's directors and officers existing on the date proceedings commence are filed as part of this process. If the restructuring plan is accepted by the company's creditors and approved by the court, the directors are released from these claims, with certain limited statutory exceptions.[2]

Directors' and Officers' Charge in Court Proceedings

The court may grant security by way of a charge (lien or security interest) over all of the company's property, which may be used to indemnify directors or officers for certain obligations and liabilities incurred during the proceedings. The court can also order that this newly-created charge will rank ahead of existing secured creditors. This protection is intended to encourage directors and officers to continue assisting and directing the company during its reorganization.

The court determines the amount of the director's charge by balancing the interests of the company's stakeholders against the aggregate amount of the potential liabilities that the charge is intended to secure (including the types of personal liabilities described above).

[2] A release in favour of directors under a CCAA plan cannot cover wrongful or oppressive conduct by directors, or misrepresentation.

Directors' and Officers' Insurance

Companies should obtain insurance on behalf of their directors, which may be difficult or expensive to obtain when a company is financially distressed. Insurers are normally prevented from terminating (or failing to renew on comparable terms) D&O insurance policies that exist at the time a CCAA proceeding begins.

Directors' and Officers' Trust

These trusts provide financial support to defend directors and officers against liability claims, thereby further easing concerns about personal liability. Normally, companies deposit a fixed sum that is made available to directors and officers when a claim is made against them while acting in their corporate capacities. These trusts are usually established to complement rather than replace directors' and officers' insurance.

Depositing cash into the trust places it beyond the reach of creditors so it will be available to satisfy claims against directors. If this is done after insolvency proceedings have begun (which would require court approval), creditors will view it as a preference made by the company in favour of its directors. This perception can easily distract and distance the company from its significant stakeholders, whose support is required for a successful restructuring.

Corporation's Duty to Indemnify

Corporate statutes such as the CBCA provide for an indemnity by the company in favour of directors in certain circumstances. Directors may also have contracts with the company that indemnify them for liabilities they incur in their role as directors. However, in the event of insolvency, such indemnifications place directors in the same category as other unsecured creditors, with insufficient cash available to repay all creditors.

Arrangements to protect directors for potential liabilities should always be put in place well before any determination of insolvency occurs. If they are implemented when the company is insolvent, they could be set aside by the court at the request of a creditor.

Part C: Stakeholders and Their Interests

8. Has the board identified the company's stakeholder groups and does it understand the mood, interests, expectations and objectives of each group? Are they likely to accept a compromise of their current entitlement and cooperate with a restructuring?

A first step towards a successful restructuring is to identify the stakeholder groups impacted by the restructuring and consider their interests when determining what is in the company's best interests. Each stakeholder group will have unique interests to be considered in analyzing any restructuring proposal. A critical component of any formal restructuring involves putting the restructuring plan to a vote by the company's creditors, who will be organized into "classes" for that purpose. There are numerical and percentage thresholds of approving creditors that must be reached in each class of creditors in order for a restructuring plan to be successful, whether under the BIA or CCAA. Some creditors will try to argue that their indebtedness is unique from all other creditors, in an attempt to obtain a veto position when voting in a class with fewer creditors or those with significantly smaller debts. The classification of creditors therefore involves both legal and strategic considerations.

Typical stakeholder groups include:

- Lenders (secured and unsecured);
- Employees and retirees;
- Suppliers;
- Landlords;
- Customers;
- Governments/pension regulators; and
- The "public interest".

Lenders (secured and unsecured)

Lenders have differing degrees of influence in a restructuring. Secured creditors will have the most power, although unsecured bondholders may also exert significant influence.

Most companies have secured operating lenders and may also have secured asset-based lenders who hold security over some or all of the company's assets. Secured lenders will not want their security positions to be eroded through the restructuring process and will insist on ongoing, accurate and timely financial reporting from the corporation.

Companies often also have secured and/or unsecured public debt from the issuance of bonds in the market place. Bondholders are usually well organized and often have significant financial acumen. They will want to protect and recoup their investment within a timeframe that suits their strategic goals, and will also insist upon accurate and timely financial reporting.

Bondholders' strategies and objectives can differ from other secured lenders. Chartered banks, for example, may be considered risk adverse and want to see the full repayment of principal, interest and costs. Bondholders, on the other hand, often purchase debt on the secondary market at less than face value and have higher risk appetites in return for higher reward opportunities. Their strategies may include a "loan to own" perspective where the end goal is taking over the company or obtaining a majority position in it through the restructuring.

Secured creditors are not in the same class as unsecured creditors for voting purposes when their interests are being impacted by a restructuring. Companies, therefore, will need a consensus among their secured creditors, in addition to their unsecured creditors, to successfully restructure their secured indebtedness.

Employees and Retirees

Although often considered one stakeholder group in a restructuring process, employees and retirees have interests that are not directly aligned. Employees have a broader set of interests that include the impact that decisions (such as the closure or sale of a business unit) will have on them and the effect of any proposed changes to their wages and benefits. Their concern will be about the corporation's ongoing viability and they will be reluctant to accept concessions unless they perceive that all stakeholders have contributed as much to the restructuring process as they believe that they have.

Post-retirement benefits and pension payments are often underfunded (in a deficit position) at the time a company commences a formal restructuring. Retirees will generally align themselves with

whatever restructuring efforts they believe will best protect their pension and other retirement benefits, since those are often their main or only source of income.

Suppliers

Unpaid amounts owing by the insolvent company are stayed by the filing of formal restructuring proceedings. Since suppliers are not usually organized or aligned as a group, they have less power than other organized groups. Supplier debt will ultimately be addressed (compromised) in a restructuring plan put forward by the company. In addition to their immediate financial stake in the restructuring, suppliers often consider the company's long-term viability and their ongoing ability to continue supplying to the company if it is successfully restructured. Suppliers whose future viability is tied to the company's ongoing operations will be more willing to accommodate the company's efforts and accept a compromise or amended terms.

Under the CCAA, insolvent companies have the right to seek an order from the court *deeming* a supplier to be a "critical supplier." If the order is granted, the supplier must continue supplying the insolvent company either on existing terms or other terms the court considers appropriate. In exchange, the supplier is granted a charge (lien) over the company's assets ahead of other secured creditors to secure payment of amounts relating to their continued supply after the date of filing.

Landlords

Depending on the company's business (such as a retail operation with locations across Canada), landlords may play an important role in the restructuring efforts. In a court-supervised restructuring process, companies have the ability to terminate leases and compromise the landlord's claim for damages within a restructuring plan. This occurs most often when a company is party to long-term leases at above-market rates, but could be utilized in any situation where the lease is not financially beneficial to the company, or not required in the future. However, landlords' interests may be determined to be unique from other unsecured creditors with the result that they may try to be placed in their own separate class for the purpose of voting on any restructuring plan, which, if successful, would help them avoid having their claims compromised.

Customers

Though they do not have a direct financial stake in the restructuring, customers are a unique stakeholder group that can be very powerful, though they generally act individually. Customers' concerns will be on the impact of the restructuring on them and whether the insolvent company will continue supplying them and maintaining ongoing services, such as warranty claims. Companies should maintain open communications with their customers to ensure that they continue dealing with the company while it restructures. Otherwise, the company will face the additional hurdle of a shrinking customer base.

Governments/Pension Regulators

Governments and/or pension regulators are playing increasingly important roles in restructurings. Although not an actual creditor with a vote in the restructuring, if changes are sought to business areas that are governed by legislation or regulation, the relevant government and/or regulator must agree to the proposed changes. Often, these changes are essential for the company's long-term viability, such as an extension of time or decreased payments to fund deficits in its pension plans.

Upon a company's insolvency, provincial pension regulators may appoint an outside administrator for the pension plan, thereby replacing the company as the plan's sponsor/administrator. In view of the uncertainty created by the recent *Indalex* decision, we can expect to see this occur more often than in the past. If the pension plan is in a deficit position and is being wound up as part of the restructuring, the outside administrator will be a creditor with a claim for the deficit under the pension plan. In some cases, that claim may be significant enough to result in the administrator having a veto over any restructuring plan.

Public Interest

Another consideration in a restructuring process may be the public interest. This may exist in situations where a company's failure to survive would have a devastating impact on the community (for example, in a single-employer town) or when the company is so significant in size or scope, or provides such an important function in the economy, that it is considered to be part of the "fabric of Canada."

Part D: Options for Restructuring

9. What options for restructuring are available to the corporation? Can the restructuring be successfully carried out out-of-court, or is a court-supervised restructuring the only viable option?

When faced with the company's potential or impending insolvency, directors usually have three options for restructuring:

(i) sell the business (either as a whole, or a particular division or location) as a going concern;

(ii) an out-of-court (consensual) restructuring; or

(iii) a court-supervised restructuring under the CCAA or the BIA.

The "best" option depends on the nature of the company's obligations, the extent to which they are secured over the company's assets, the number of creditors with which an agreement needs to be reached, and whether the company needs to be protected by a court-ordered stay of proceedings while it negotiates its restructuring. For example, if liabilities with a secured lender can be negotiated with that party alone, and amendments to existing credit facilities can be reached on a bilateral basis, court proceedings or the support of other stakeholders may not be necessary. On the other hand, companies that are unable to meet imminent special payment obligations under a registered pension plan would not usually be able to address that situation outside of a court proceeding, due to the complex legal and regulatory framework governing such plans.

Selling the Business

Selling the business as a going concern may be an option when there are divisions or business lines that may be attractive to industry players or others who could invest in upgrades, consolidate or integrate with another business line or secure the necessary financing to make that business profitable. This type of restructuring would need to be supported by the secured lenders who hold security over those assets and would generally be viewed favourably by employees, customers and suppliers when the purchaser intends to carry on the business as a going concern. Directors need to consider whether it is in the corporation's best interest to sell the business as a whole or in part. If an Ontario company is considering selling a division or business line, it must also be satisfied that the sale does not constitute a "sale in bulk" so as to bring into play the provisions of the *Bulk Sales Act*.[3] Compliance with the statute can be onerous, expensive or impractical in view of the notice and consent requirements. A more common manner of proceeding is to obtain a court order exempting a sale from the provisions of the statute, if the facts support such an exemption.

Out-of-Court Restructuring

Out-of-court restructurings have the benefit of being significantly less costly than court supervised ones. However, since the restructuring is done without the benefit of a court-ordered stay of proceedings, counterparties may terminate contracts, creditors may enforce their rights, and service-providers may withdraw their services or amend terms including as to payment. Directors also lack many of the protections against personal liability that are available under a court order. However, when the issues are narrow, creditors are few and are supportive, and the consequences of formal proceedings would be particularly detrimental to the business' operations, an out-of-court restructuring may be a viable alternative.

Court-Supervised Restructuring

When there are issues that cannot be resolved through negotiations alone, formal insolvency proceedings are often the best or only option.

The primary benefit of a court proceeding is that it provides the ability to obtain a stay of proceedings, which prevents parties from terminating contracts with the company, exercising rights of enforcement or discontinuing services. Under a stay of proceedings, the company retains its assets and rights and is entitled to continue operations without the threat of enforcement by its creditors. As a result, no single creditor, supplier or employee group can control

[3] R.S.O. 1990, c. B.14, as amended . Ontario is the only Province that continues to have a *Bulk Sales Act* in force.

the restructuring process at the outset and the company is insulated from the otherwise negative effects of admitting its insolvency. Without a stay of proceedings, the admission of insolvency to a company's creditors may trigger rights of termination or defaults under various contracts with the result that licenses may be revoked or not renewed.

On the other hand, court proceedings involve substantial costs and may have a negative effect on the business due to uncertainty arising from a lengthy proceeding. They also have the potential for decreased control since it gives stakeholders a forum (the court) in which to take an active role. Companies that embark upon a restructuring process are often taken in unforeseen directions. For instance, a company that starts to restructure debt may receive a buyout offer.

There are other drawbacks to beginning formal proceedings when the outcome is uncertain, such as when making a formal proposal to creditors under the BIA. That statute contains specific timeframes within which a proposal must be developed and presented to creditors. If the proposal is not approved by a majority of creditors and two-thirds in value of all unsecured creditors, the corporation is automatically bankrupt.

Debtor in Possession Financing

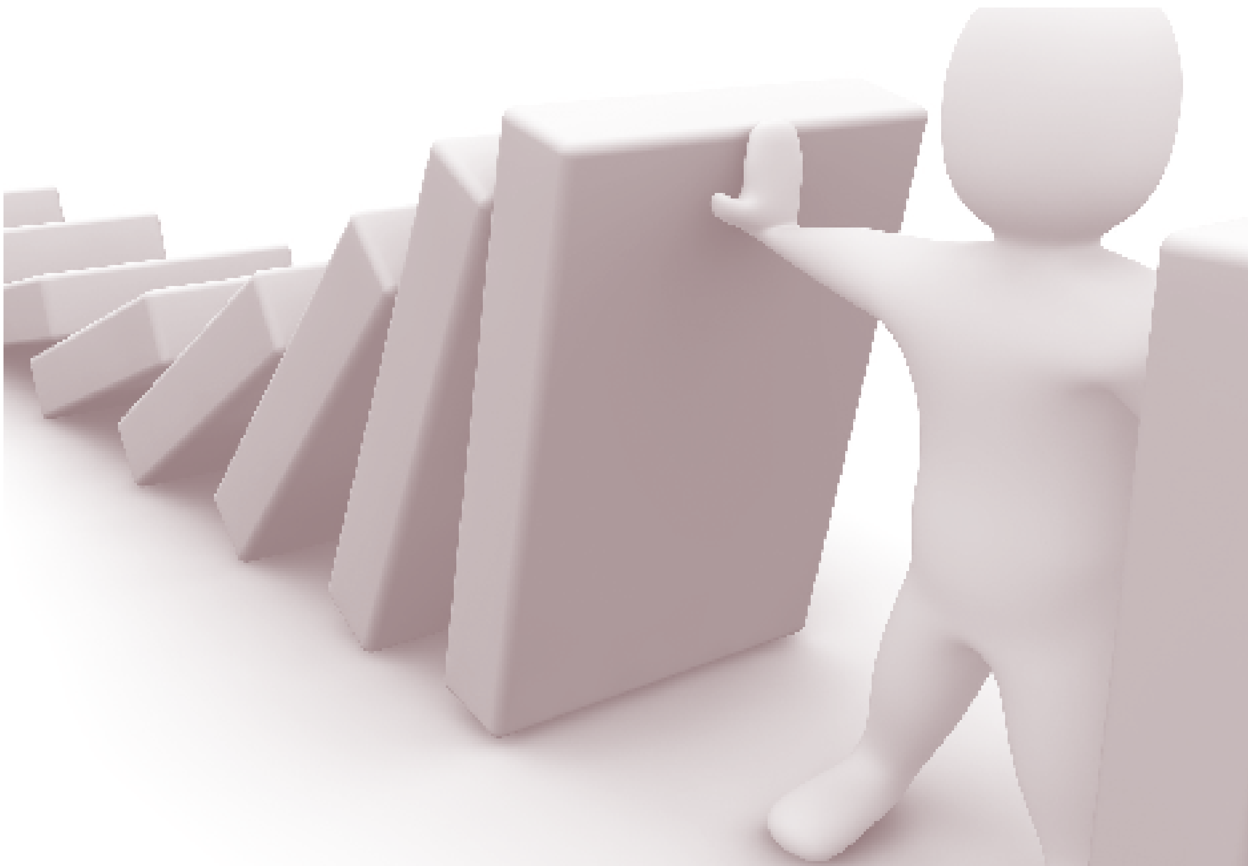
Court-supervised restructurings are expensive since the company must retain insolvency and restructuring lawyers, and also pay for restructuring specialists, a monitor or other officers appointed by the courts, a claims officer, and counsel for these parties. Other professional costs may include agents or counsel in other jurisdictions. Furthermore, while the payment of "pre-filing" obligations (those existing at the date of filing for court protection) will be stayed, the company will have to pay for all goods and services delivered on or after the start of the court-supervised restructuring process, often on a "cash on delivery" basis.

Insolvent companies can rarely cover these expenses from general operating cash flows and, therefore, normally need to seek debtor-in-possession ("DIP") financing. Lenders are not willing to advance funds to an insolvent company (which, by definition, represents a poor credit risk) unless they are given clear priority for the new advances over all other parties. DIP financing is granted by a court order and includes a court-ordered charge over all of the insolvent company's property to secure payment of the DIP financing in priority to all creditors. DIP lenders may impose very onerous reporting and approval requirements.

Lenders who advanced funds to the company before it became insolvent often extend DIP financing as a way to better ensure their existing loans will be repaid and protect their security position from being impaired by court-ordered charges that favour other lenders. An existing lender's willingness to advance DIP financing may be greatly influenced by its relationship with the company's senior management. If the lender loses faith in management's ability to manage costs or operate the business, or in the credibility of financial and other information that management provides to it, that could result in a crucial loss of support when the company needs it most.

The court's authorization of DIP financing effectively imposes a new layer of secured debt onto an existing pool of assets that is already too small to support full payment to all creditors. Courts understand that DIP financing is necessary and that a court-ordered first priority charge to secure such financing is appropriate, notwithstanding the impact the additional debt may have on unsecured creditors who must bear the burden of new debt that must be repaid in priority to them. Nevertheless, those same unsecured creditors may also benefit if the restructuring results in a more viable business, which may not be possible without DIP financing. The *Indalex* decision referred to above has created uncertainty for lenders providing DIP financing, as the Ontario Court of Appeal in that case granted priority to the beneficiaries of a wound-up, underfunded pension plan for the entire deficit, over the interest of a DIP lender which had been granted super-priority under a court order.

Before beginning formal insolvency proceedings, directors should consider the company's financing requirements during the proceeding, the additional funding that may be warranted, the availability of financing and whether obtaining that funding (with a charge ranking ahead of existing creditor interests) is in the company's best interests. If the court authorizes the company to obtain DIP financing and grants the new charge, directors can take



comfort from the protection afforded by the court provided they act in good faith. DIP financing will, however, add additional reporting requirements and necessary approvals to all significant steps in the process.

Other Situations that Normally Require a Court Proceeding

In addition to the benefits of a stay of proceedings and the ability to obtain DIP financing, other reasons why companies usually initiate formal restructuring proceedings are described below.

Protection for Directors and Others

A formal court-ordered charge on the insolvent corporation's assets in favour of the directors has the effect of insulating them from the financial impact of having to deal with these claims. Without a court order, secured creditors who have an existing charge over the company's assets would be unlikely to agree to the creation of a priority charge in favour of the company's directors. In addition, the granting of security by an insolvent company could be subject to attack by creditors.

Final Resolution of Claims

Even when agreements can be negotiated with all the affected stakeholders outside a formal insolvency proceeding, some creditors may re-assert their claims at a later date, placing the company back into a period of uncertainty. A successful, formal restructuring proceeding results in a permanent compromise of all claims against the company, bringing certainty and finality to the situation.

Business or Assets in Another Jurisdiction

When most of the company's assets are located abroad, a foreign court may be the primary venue where claims are adjudicated. Canadian courts will implement orders issued by the foreign court provided they are consistent with Canadian insolvency principles. When considering whether to begin formal insolvency proceedings, it is important to determine whether the company has appropriate

legal representation in the jurisdictions in which its assets are located.

Authority of a Court Order

A formal court order is a valuable tool when particular contractual or statutory obligations would otherwise represent an obstacle to a successful restructuring. For example, a court may order critical suppliers to continue supplying the insolvent company subject to certain terms; relieve the insolvent company from an obligation to pay certain amounts that are required by statute to be paid; permit the termination of unfavorable or unnecessary contracts; allow assets to be disposed of out of the ordinary course of business; or create a charge in favour of its directors and professional advisors assisting with the restructuring.

Choice of Statute

10. Should a proceeding be commenced under the relevant corporate statute, the BIA or the CCAA?

The determination of whether a formal restructuring proceeding should be commenced under the relevant corporate statute (such as the CBCA) or an insolvency statute (such as the BIA or CCAA) will depend entirely on whether the company is solvent or insolvent. If solvent, it can only utilize the corporate statute. If insolvent, it must look to the BIA or the CCAA.

In the case of an insolvent company, the next decision facing directors is whether the restructuring should proceed as a proposal under the BIA, or a plan of arrangement under the CCAA. The facts of each case will largely dictate which proceeding is more appropriate, but there remains a significant degree of judgment in determining which path can best achieve the company's goals. The differences between a restructuring proceeding under the BIA or the CCAA can broadly and generally be summarized as follows:

(i) the preparation of a notice of intention to make a proposal ("NOI") under the BIA and related documents can be prepared in one day, and does not involve a court appearance. The application materials to commence a CCAA proceeding are voluminous, expensive to prepare and require a court attendance;

(ii) upon the filing of a NOI or proposal under the BIA, there is an automatic (statutory) stay of proceedings preventing all parties from taking any action against the company. The commencement of a CCAA proceeding does not involve an automatic stay, but is at the discretion of the court in granting the Initial Order. The initial stay in a CCAA proceeding cannot exceed 30 days, subject to a return attendance in court to obtain a further order for an extension;

(iii) there is no minimum "threshold of debt" in order for a company to file for protection under the BIA. In order to commence a proceeding under the CCAA, the company must have at least $5 million of outstanding indebtedness. Practically speaking, unless a company has substantially more than $5 million in debt, the costs of a CCAA proceeding may make that option much less attractive than would otherwise be the case;

(iv) once a NOI is filed under the BIA, a proposal must be filed within six months. Although there are creative and limited ways of mitigating the impact of this statutory requirement, it remains a very real consideration at the outset. There are no similar time restraints under the CCAA, and many proceedings continue for more than a year before a plan is put forward to the company's creditors;

(v) if a proposal is presented to creditors under the BIA and not accepted, the company is automatically bankrupt. There is no similar automatic result under the CCAA, although a company generally continues to negotiate its plan until such time as it can be assured of a positive vote at a meeting of creditors;

(vi) BIA proceedings are designed as single-entity filings, and therefore are not as conducive to situations involving various members of a corporate group, all of whom need to file for protection and restructure under a formal proposal. By contrast, most proceedings under the CCAA involve various members of a corporate group in one proceeding, which can be for procedural

purposes only, or in order to address the corporate group as consolidated for the purposes of a single plan of arrangement;

(vii) BIA proceedings are considerably less costly than CCAA proceedings. A BIA proposal proceeding is undertaken pursuant to clear statutory provisions including standard form documents, stipulated timelines, a mandated claims process and specified deliverables. Court appearances are infrequent, and may only involve final approval of the proposal that's been accepted by the company's creditors. By contrast, every aspect of a CCAA proceeding involves an attendance in court to obtain an order permitting various aspects of the restructuring to proceed, to create a process for determining claims, to determine disputes that arise throughout the proceeding, to obtain extensions of time for the stay of proceedings, and all aspects of the plan to be presented to creditors.

Based on a consideration of the above and other factors, the directors will determine which route is in the company's best interests, and is most likely to achieve the objectives that have been identified.

The Role of a Monitor

11. If the company plans to restructure under the CCAA, has a firm been identified to act as monitor? How soon will that firm begin working with the company to prepare the necessary financial analyses and advise on other steps the company needs to take?

A monitor is a qualified accounting firm or similar firm that is appointed by the court to monitor the corporation's affairs during a CCAA proceeding. As an "officer of the court," the monitor's primary accountability is to the court, notwithstanding that the monitor is selected by the company and proposed to the court at the time court proceedings commence. The monitor provides independent oversight of the company's activities during the CCAA process and acts as an accountability check for the benefit of the company's creditors and the court.

Monitors have an accounting and restructuring background and must be licensed trustees, which ensures they are professionally trained and examined for their competence. These requirements also ensure that the monitor is accountable for errors or omissions, and licensed trustees are subject to a disciplinary process. The company's auditor or accountant is disqualified from acting as monitor, as is anyone who may have held those positions in the two years prior to the filing.

When considering filing for protection under the CCAA, directors should consider who will act as prospective monitor. Before beginning an insolvency proceeding, the prospective monitor will help the company prepare a restructuring cash flow for the period following the filing for protection. This will differ from a typical cash flow in that it will reflect the impact of the stay of proceedings and non-payment of liabilities that exist as at the filing date. The prospective monitor will also consider the company's need for DIP financing and whether any creditors are critical to the ongoing operations during the restructuring, such that certain pre-filing payments may have to be made to guarantee the supply of goods or services throughout the restructuring period.

The prospective monitor can also lend its oversight and experience to help directors and management determine whether filing for protection is in the corporation's best interest.

Part E: Managing the Restructuring

12. What are the issues that board members need to consider in managing the restructuring?

No two restructurings are exactly the same, but all generally follow the same stages:

(i) Identifying stakeholders and their interests;

(ii) Arranging for a process of meaningful communication;

(iii) Dealing with immediate relationship issues arising from the insolvency filing;

(iv) Sharing information about the company's need to restructure;

(v) Developing restructuring alternatives; and

(vi) Building consensus around a plan of restructuring.

The ultimate issues surrounding the company's restructuring are preceded by several preliminary issues. In the early stages, many stakeholders and their advisors will want to determine their individual status and identify how they will be dealt with in the period prior to the restructuring.

The tone set in dealing with stakeholders during this period will often persist for the balance of the restructuring. Most stakeholders and their advisors are professional and civil in their initial requests for information and sorting out immediate relationship issues. Often, however, a group of stakeholders will engage in aggressive tactics in an attempt to gain an advantage over other creditors or influence the ongoing restructuring process. Directors must ensure that early requests for special treatment, such as payments for advisors to particular stakeholders, are made in the context of what is best for the company and its restructuring.

As the process moves into the middle phase of developing the restructuring alternatives, the board should be kept advised on a frequent and "real time" basis. Often, boards delegate some of this activity to a Restructuring Committee, although every board member must be familiar with the various options so that meaningful discussions about the alternatives can occur.

In the final phases, both management and the company's advisors will be actively involved in building a consensus around the proposed restructuring plan. Directors will be called upon to react to the dynamic negotiation process and provide instructions and leadership to management.

Hiring a Chief Restructuring Officer

13. Should a chief restructuring officer be engaged to lead the restructuring and to allow management to focus on ongoing operations? If so, have CRO candidates been identified and a CRO reporting structure determined?

When some form of restructuring is likely, directors must decide whether existing management has the required expertise and ability or whether a chief restructuring officer ("CRO") should be retained. This role is in addition to that of a court-appointed monitor in the case of restructurings conducted under the CCAA. If a CRO is to be retained, directors need to determine the appropriate reporting structure. Alternative structures may include:

(i) the CRO replacing the CEO;

(ii) the CRO reporting to the CEO; or

(iii) the CRO reporting to the board.

When a company is insolvent, management's time and resources are stretched by the need to address the increased supplier demands, renegotiate credit terms and other agreements, maintain customer relations, establish or preserve market share, and prepare the many cash flow forecasts, budgets, business plans and increased reporting and financial models that are often requested by the company's lenders. In these situations, management may easily lose focus on the critical task of efficiently running the business. In some cases, a CRO (whether formally holding this title or otherwise) can help navigate the restructuring, while allowing management to remain focused on the core business that is to be restructured.

While management usually has a deep understanding of all aspects of the company's business, markets and industry, they typically lack experience in insolvency restructurings. Conversely, a CRO may have considerable experience in restructuring insolvent companies, but limited exposure to the industry in which the company operates. This can be a benefit if it enables an experienced restructuring professional to view the business and its operations as a whole and recommend difficult decisions free from emotional or historical attachments felt by existing management.

A CRO can also be a helpful buffer to management when difficult decisions need to be implemented, such as employee reductions or facility closures. A CRO has no "baggage" and is typically seen as independent by key stakeholders and, therefore, can help facilitate a resolution among key stakeholders and coordinate other advisors. For all these reasons, appointing a CRO may be in the best interests of the company and its stakeholders.

Appointing a CRO can publicly signal the company's commitment to the restructuring, help avoid the appearance of bias and make court proceedings more transparent since CROs are often perceived as neutral "facilitators." This perception can be enhanced when the CRO reports to the board, which is perhaps the most effective reporting structure.

Finally, a CRO can oversee and coordinate the increased financial and related reporting that is usually requested by the company's existing lenders or other professionals hired to advise on the restructuring. This reporting often includes preparing financial models to show the outcome of various restructuring scenarios, detailed cash flow forecasts reflecting a number of variables, modified borrowing base calculations or related financial information. A CRO (or more typically, a monitor under the CCAA) can assess whether the company's existing financial and accounting resources are sufficient to address those needs, especially in a formal insolvency proceeding, or if additional resources are required.

The most effective means of ensuring that a CRO adds value to the restructuring is to clearly delineate the CRO's role and responsibilities relative to existing management. Hiring a CRO will change management/board relations, but this is not a good reason for refusing to hire one. When considering whether introducing a CRO is appropriate, directors must focus on their primary legal obligation, which is to make decisions that are in the best interest of the company.

A CRO will also be the primary party to interface with the court-appointed monitor in a CCAA restructuring. As such, directors should ensure that the monitor has full confidence in the CRO, that lines of communication and responsibility are clearly understood and implemented, and that any indications of a loss of confidence, credibility or miscommunication on the part of the monitor are relayed to the board so that they can be proactively addressed.

Retaining Restructuring Advisors

14. What types of outside advisors with restructuring experience and special expertise (such as human resources, pensions and communications) need to be considered to assist the company during the restructuring?

In addition to a CRO, other expertise is often required if the restructuring is to succeed.

Lawyers

Lawyers with insolvency and restructuring expertise should be retained as soon as the company finds itself in financial difficulty. Too often, companies attempt to rely solely on the advice of their general corporate counsel. Management may believe that existing counsel who served the company well for many years are in the best position to continue to do so. However, if that long-standing relationship has created a bias towards management, it could influence the counsel's perceived independence.

Existing counsel likely are not insolvency or restructuring lawyers, which is a specialized and highly technical field. The company needs counsel with the experience to identify and address all the relevant legal considerations when faced with insolvency. Delaying the retention of specialized restructuring counsel can seriously affect the company's ability to restructure, as it may result in

options being no longer available due to its worsened financial position.

Accountants

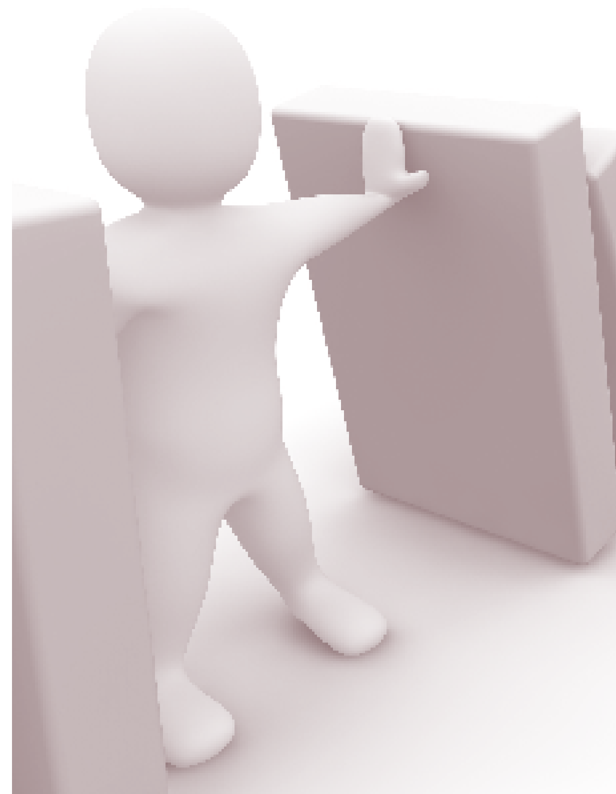
Corporations should consider retaining accountants or similar professional consultants with restructuring expertise who are separate and apart from the company's auditors. In the event of a formal CCAA proceeding, the company's auditor cannot act as Monitor. A licensed trustee in bankruptcy from an accounting firm, for example, can help prepare the financial modeling required to consider all restructuring options. They may also be able to take the lead in communicating the company's financial situation to its stakeholders, which will allow management to focus on the core business. If the corporation is to enter a formal restructuring process, restructuring accountants will be in a position to transition into the role of monitor, in a CCAA restructuring, or proposal trustee within a BIA proposal process. By assisting the company with its analysis prior to a court filing, the restructuring accountants will be well-informed to report to the court and stakeholders with respect to the company's financial affairs and its restructuring efforts.

Investment Bankers

Investment bankers can help the company access additional capital, restructure its balance sheet, determine whether to sell all or a portion of its business and find purchasers or equity partners. Investment bankers have expertise in accessing capital markets; locating and negotiating the terms of a "stalking horse" type transaction, which provides a starting point in a marketing and sales process; conducting a marketing and sales process; negotiating with proposed bidders; structuring a sale or other transaction in the marketplace; valuing the proposed restructured business; and assessing the closing risks associated with various proposed transactions.

Industry Experts

Industry experts can add value to a restructuring by helping to project future trends in the company's industry, which would help the directors consider which business units should become the core business of the restructured corporation. They can also help the company determine steps



to automate the business and determine long-term growth strategies to enable the viability of the restructured business. Industry experts can add credibility to company presentations/communications to outside stakeholders.

Human Resources Specialists including Pension Experts and Actuaries

Often, directors of insolvent companies have to oversee significant reductions in the company's workforce and/or make substantial changes to employee benefits, including pension plans. Human resource specialists, including pension experts and actuaries, can provide specialized advice regarding underfunded pension plans, initiating pension plan windups, assessing and re-evaluating benefits entitlements and analyzing issues arising under collective agreements. Human resource specialists can also help the corporation achieve buy-in from employees regarding changes to pension plans by helping to explain why the changes are necessary to ensure the viability of the business, the actuarial cost of the benefits, and any changes to the funding mechanism or the type of pension benefits provided.

Communications/Crisis Consultants

Insolvency can create confusion, panic and anger among the people whose support is needed most for the company's restructuring to succeed: employees, suppliers, customers and other stakeholders. Companies need an effective communication plan to keep these stakeholders fully apprised of and supportive of the restructuring. Large public companies usually have media or public relations departments or employees who can carry out this task. Companies without such a communication protocol may find it helpful to hire a media consultant or an experienced individual to help develop and communicate its messages. In the case of a formal proceeding pursuant to the CCAA, the monitor appointed by the court can also assist the company in these efforts.

Communications During Restructuring

15. Has the board identified who will be responsible for developing and implementing the communications plan, and has such a plan been put in place? Has the board identified the specific individuals who will act as primary liaisons with key stakeholders?

Before starting a formal restructuring proceeding, employees, customers, suppliers and other key stakeholders must have confidence in the ability of management and the directors to guide the company to emerging as a viable, ongoing business.

A successful restructuring requires an extensive and effective communication plan that begins well in advance of any formal insolvency proceeding. Such a plan may involve use of the media to report on current issues facing the company and the means by which management is seeking to address these issues. Providing accurate information also forestalls speculation, which can be disruptive to the restructuring process.

Without an effective communication plan, the business or financial issues that are most in need of restructuring typically worsen. Customers may make alternate arrangements, suppliers may refuse to continue dealing with the company, projections provided to the operating lender may not be met, credit may be compressed further and the company's efforts to restructure may prove to be too little, too late.

Relationships are integral to any business' success, especially when facing insolvency. The success of a restructuring depends upon the willingness of a company's creditors and other stakeholders to support it. The appropriate people need to act as primary liaison and "relationship managers" with key customers, suppliers and other stakeholders so that these groups feel they are participants in, rather than observers of, the company's restructuring efforts and know that their support is recognized and appreciated.

For further information on communications during restructuring, see: 20 Questions Directors Should Ask about Crisis Management.

Public Disclosures and Other Statements

16. Has the board reviewed the company's disclosures to ensure they comply with all regulatory and statutory disclosure obligations and fairly reflect the company's financial position? Do other communications, formal and informal, by management and the board fairly present the company's financial position?

Directors of public companies who authorize materially incorrect disclosures could face liability under the *Ontario Securities Act*. Failure to make timely disclosures of material changes, including changes in the company's solvency, may lead to personal sanctions against a director.

Directors also need to take care about other communications made regarding the company's financial stability or solvency, including statements given or authorized by the board that are communicated by the company's senior officers. Directors and senior management may be subject to personal sanctions, including under the *Ontario Securities Act*, for failing to disclose accurate information concerning the company's financial position, including remarks made informally.

Changes to the Original Restructuring Plan

17. Does the board receive regular updates on the dynamics of the restructuring process, including changes in stakeholder positions and attitudes and how they may impact the success or failure of the proposed restructuring?

Often, a board will begin a restructuring with an idea of what the company should look like coming out of the process. The restructuring plan may focus on essential flaws in the business that led to the need to restructure. This may include unsustainable debt levels, crushing legacy pension and post-employment benefit costs, antiquated and unprofitable facilities or business lines or other factors that need to be remedied in order for the company to be sustainable over the long term. These initial assessments are made against current and projected market conditions, and usually assume viable, ongoing operations following a successful restructuring. When Nortel filed for protection and commenced an insolvency proceeding it did so with a view to effecting an operational and financial restructuring, and then emerging as a viable, going-concern business. Within months of filing, it became clear that the restructuring had become a liquidation.

Once the restructuring begins, the plan and its underlying assumptions become subject to the dynamic events of the restructuring process. General economic conditions, prices and production levels, the cost of financing, the availability of credit and other factors may all change. In addition, stakeholders seeking leverage may find temporary opportunities to take advantage of the restructuring process. For example, the expiration of a collective agreement may give greater power to the threat of a strike. On the other hand, a temporary suspension of production may be just the break the restructuring process needs to bring stakeholders to a point of making serious decisions.

In addition to extraneous events affecting both a financial and operational restructuring, the dynamics of the negotiation process will have considerable influence. The willingness of disparate groups of stakeholders to form alliances may affect the negotiation dynamic. For a formal restructuring to succeed, it must be approved by a requisite number of creditors holding a requisite amount of the debt. In addition, other stakeholders may hold a functional veto arising from contractual or other relationship rights, such as the ability to supply a critical input to the business. Often two groups, neither of whom individually control the process, will combine forces to place themselves in a position to take control. Directors need to be kept closely informed of all such developments and their impact on the proposed restructuring plan.

During a restructuring, new players often enter the field looking for opportunities, such as to purchase all or part of the business or provide financing in the form of post-restructuring debt or equity. Often, these players enter the process by purchasing the interests of existing stakeholders. It is also common for debt to change hands and become consolidated in a few players during the restructuring process. This, combined with an outsider's perspective, may lead to changes to the original restructuring plan.

Directors must understand these factors and ensure they remain fully informed in order to make decisions in the company's best interests.

Part F: The Restructuring Vote

As the restructuring progresses, management and their advisors need to constantly evaluate the likelihood that stakeholders will accept a compromise of their entitlements instead of forcing the corporation into liquidation. Directors need to be kept apprised of this dynamic analysis to determine when it is in the company's best interests to put the proposed restructuring to a vote. Similarly, directors need to communicate openly with stakeholders about the state of the company's affairs and possible restructuring options.

Each stakeholder group will analyze the restructuring from its own unique perspective. As the concerns of the stakeholder groups evolve, a "power grid" of stakeholders will influence particular perspectives. At any given time, certain stakeholder groups may favour a failed restructuring over the company's proposed compromises for reasons not always related solely to the financial outcome for that stakeholder group. For example, a union may see a restructuring as a sign of what is to come based on industry-specific changes and may, therefore, not want to be viewed as accepting concessions on its members' behalf if those concessions may become the starting point in negotiations for the restructuring of the next insolvent company within that same industry.

Some stakeholders may not accept a compromise if they believe the company's financial situation is not as bad as what is being portrayed. Initially, many stakeholders may hold this view because it provides leverage and keeps pressure on the insolvent company to satisfy them that the compromise is absolutely necessary to the company's future. In a restructuring, this dynamic may be compounded when debt changes hands after being purchased in the market. Debt is usually purchased at a discount, based on the purchaser's analysis of the insolvent company's underlying value. These newcomers to the restructuring process may have very different opinions about what they are prepared to accept as a return on their investment. Some may be prepared to drive the company into liquidation if they believe their recovery won't be substantially different under a liquidation or a successful restructuring.

Assessing a Proposed Restructuring Plan

18. Does the proposed restructuring plan address stakeholder interests equitably and fairly?

While competing stakeholder groups may have different views about the directors' best course of action, the directors' fiduciary duty is to the company alone. Successfully addressing the company's financial problems could improve the positions of creditors and other stakeholders and may even retain value for shareholders (although, under the CCAA, shareholders can only be paid after all creditors are paid in full). If a restructuring is unsuccessful, the fact that it has not been accepted by the company's stakeholders does not mean that the directors' actions in supporting it constitutes a breach of fiduciary duty. The test will be whether, acting on an informed basis having regard to all relevant facts and the interests of the company's stakeholders, the directors made decisions that they believed in good faith to be in the best interests of the company.

Courts are reluctant to second-guess the decisions of directors, and generally defer to their business judgment. This is reflected in the "business judgment rule," which accords deference to business decisions of directors who perform their functions in good faith. This reflects the fact that directors, who are mandated to oversee the company's business and affairs, are usually best suited to determine what is in the company's best interests. However, when determining a company's best interests, directors must consider the interests of all stakeholders. Even when a company is insolvent, the interests of creditors will only prevail where those interests coincide with the best interests of the company.

The board's responsibility, therefore, is to consider all options that could result in a stronger, more viable company (or maximize the realizable value of the assets if no ongoing operations are possible) rather than try to placate the interests of any one group of stakeholders. When presented with the potential means to address the company's insolvency, the board needs to decide whether the proposed plan will likely accomplish that purpose. This assessment will normally be qualified by

assumptions about the future company, industry-specific trends and factors, and the direction of the overall economy. If the board's decision is subsequently challenged, the issue will not be whether the board successfully predicted the future, but whether the board asked the proper questions and received appropriate answers to them.

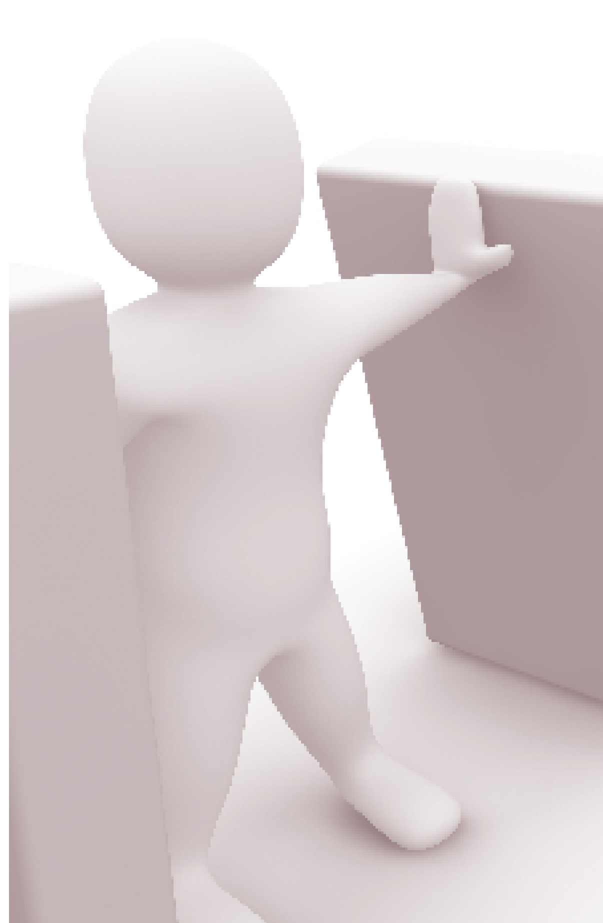
Putting the Restructuring Plan to a Stakeholder Vote

19. Once a deadline for a vote has been announced, is the board confident that the company will emerge successfully?

The company will "successfully emerge" from insolvency protection if it obtains the requisite support of its stakeholders. These stakeholders can be placed into two broad categories – those with a functional veto over the process and those without one. As noted above, some stakeholders without a functional veto over the process at the outset of the restructuring may gain one by combining forces with other existing stakeholders or with outside interests. In addition, as time passes events may increase or decrease a stakeholder's leverage in the restructuring process. The negotiation process will be highly influenced by these changing dynamics.

In some instances, the negotiation process results in an agreement between the company and a sufficient group of the stakeholders to achieve approval of the restructuring. When this occurs, the plan should be put to a vote.

A more difficult situation arises when a consensus cannot be achieved. The dynamics of the negotiating process will be determined by the willingness of the stakeholders holding a veto to suffer the consequences of a failed restructuring. This willingness may vary significantly depending on the type of industry. For instance, very few stakeholders will benefit from the failed restructuring of a legacy primary industry since the assets are often of little residual value and may be encumbered by environmental liabilities. On the other hand, a real estate company may have little value over and above the value of its individual assets. When an agreement cannot be achieved through negotiations, directors will eventually



have to test the stakeholders' positions by putting the matter forward for approval.

20. Is the board monitoring for events or intervening factors that will bring the restructuring negotiations to a conclusion?

External events sometimes create a crisis or sense of urgency to bring the restructuring negotiations to a conclusion. These events may be as mundane as a pending change of season, if that would affect the company's ability to generate cash, or as dramatic as a major turn in the economy. Once these events are recognized by all stakeholders, there will likely be a natural deadline to work toward, which will make decisions surrounding timing much more obvious. Other events may also be generated by stakeholders within the restructuring, such as the party providing the DIP financing who becomes frustrated by the stubbornness of other stakeholders and threatens to cut off financing by a certain date. In such a case, when the

business has no other financing, that looming crisis will set the date for the end of negotiations.

In the absence of a crisis, the directors will have to decide when to declare an end to the negotiations and put the choice of supporting the restructuring or liquidating the assets to the stakeholders. To make this decision, the board needs to be fully briefed and familiar with the entire restructuring landscape. Declaring a deadline and allowing it to pass without obtaining significant benefits for the company will severely reduce the negotiating leverage of those attempting to negotiate on the company's behalf. For this reason, the issue of timing must be taken seriously and directors should avoid false cries of the impending end of the process.

Conclusion

Boards of companies that are successful in having a restructuring plan approved by their stakeholders often continue to have a range of restructuring related issues to be addressed. For example, the restructured company is often significantly different from the pre-insolvency company, requiring different management expertise (or new management is required because the former team is too associated with the old corporation and its failings).

The board itself may need to be refreshed, either because existing board members departed during the restructuring or feel they should do so after having seen the restructuring through to completion, or because the restructured company is different enough that different skill sets and expertise is required.

In addition, the board and management will often need to rebuild relationships with employees, suppliers, customers, and other stakeholders who remain with the company since their relationships with the company may have changed significantly during the restructuring.

Restructuring an insolvent company is a complex and time-consuming undertaking for the corporation, its various stakeholders and the directors. The more prepared the company and its directors are, the greater the likelihood of a successful restructuring.

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*Available at www.rogb.ca.

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Michael Barrack is a litigator with Thornton Grout Finnigan LLP. He has litigated at every level of court in Canada, as well as at the London Court of International Arbitration. He has led dozens of cases ranging from criminal jury trials to civil and constitutional appeals before the Supreme Court of Canada. He has been described as an assertive litigator who is very strategic and creative, with effective examination skills and persuasive advocacy techniques.

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Michael has been named in many lawyer listings, including being named one of the 100 most creative lawyers in Canada and recognized in Chambers Global, Best Lawyers, Lexpert Leading 500 Lawyers in Canada, Who's Who Legal International and Expert Guides to the World's Leading Litigation Lawyers.

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Ms. Miller co-developed and taught a course in Advanced Insolvency Law at the University of Windsor Law School, and is a guest lecturer at the Faculties of Law for University of Western Ontario Law School and Queen's University. She is regularly requested to speak at conferences and is the author of papers on various issues affecting her clients.

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