

ABCP Crisis: The Canadian Solution

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These are tumultuous economic times in North America and throughout the world. As the United States continues to struggle to stabilise its failing economy and allay the fears of anxious investors, Canada has taken a step towards restructuring, at least part, of its financial crisis. Canada's unique solution to its asset-backed commercial paper ('ABCP') crisis is unique and innovative, but is not without controversy.

Background to the ABCP crisis in Canada

In Canada, ABCP is issued by two groups: (i) banks, and (ii) third parties (non-banks). The restructuring of the ABCP market in Canada involved paper issued by third parties totaling approximately USD 32 billion.

Prior to the collapse of the ABCP market, these third parties, also known as 'Sponsors', would create trusts or 'Conduits' to make ABCP available to investors at attractive interest rates. The Sponsor would arrange for the purchase of the assets held in the Conduit and promote the sale and distribution of the ABCP issued by the Conduit. A Conduit is a special purpose instrument, usually in the form of a trust, which is created as a legally distinct entity from the Sponsor. ABCP is issued by a Conduit pursuant to a trust indenture which appoints a trustee to serve as trustee for the investors. The money generated from the sale of notes is used to purchase assets to be held by the trustees of the Conduits. The indenture limits the repayment under each note to the assets held by the trust for that series of notes.

ABCP typically has a short term maturity date (usually between 30 and 90 days) but the underlying assets have longer maturity dates. In Canada, much of the ABCP is backed by traditionally reliable assets, such as credit card receivables, auto loans, and conventional mortgages. The value of each note is directly connected to the value of the underlying asset.

When the paper matures, the Conduits are required to have sufficient funds to satisfy the investors. The fact that the maturity of the notes and the underlying assets are mismatched did not hinder the ABCP market initially. Many investors did not require repayment of the paper on maturity and instead, reinvested or 'rolled' their ABCP on maturity. Funds were also generated by

the Conduits by issuing new tranches of ABCP, the proceeds of which were used to pay the holders of the maturing paper when required.

In order to provide additional security for investors, many of the trustees of the Conduits entered into arrangements with liquidity providers ('Liquidity Providers') in respect of certain series of notes. These arrangements were typically made with third party lenders who agreed to provide funding to repay maturing ABCP note-holders in case of a 'market disruption'.

Among the multitude of low-risk investment opportunities, ABCP was billed as being second only to government paper in terms of its likelihood for repayment. In Canada, ABCP is rated by the Dominion Bond Rating Service ('DBRS'). Prior to the collapse of the ABCP market, most of Canada's ABCP was given the highest rating awarded by DBRS. Shortly thereafter, DBRS announced that it would review its rules for grading ABCP in Canada.

The cause

As a result of the subprime mortgage collapse in the United States, many Canadian investors began to question the liquidity and value of the assets backing their commercial paper. Most investors are not aware of the nature of the assets underlying their commercial paper. The lack of transparency resulted, in part, because of the fact that the assets underlying the paper were purchased contemporaneously with the sale of the paper itself. Due to this lack of transparency, investors assumed the worst and stopped buying and reinvesting in ABCP. As Conduits were thus unable to generate further funds, this subsequently resulted in a lack of available funds to repay maturing ABCP.

Many Conduits looked to the Liquidity Providers to fund the shortfall. The Liquidity Providers, in response, advised the non-bank Sponsors that a 'market disruption' had not occurred and that the terms for provision of liquidity had not, therefore, been met. As a result, they refused to cover the shortfall. It was clear that the bottom was going to fall out of the ABCP market and that holders of non-bank ABCP were not going to be repaid upon maturity. In other words, the non-bank ABCP market instantly became insolvent.

The fall-out

Many of the key ABCP market players met on 15 August 2007 to discuss the absence of liquidity in the market and possible solutions to the crisis. On 16 August 2007, two days after the non-bank ABCP providers announced that the liquidity they sought had been refused, these market players, comprised mostly of note-holders, entered into a standstill agreement which has generally become known as the 'Montreal Accord'.

The standstill agreement froze the ABCP market for 60 days to allow industry representatives an opportunity to develop a long-term solution to the crisis. The Montreal Accord prohibited the note-holders from realising on security while they attempted to work with the insolvent Conduits to develop a plan to restructure all outstanding third party ABCP.

On 6 September 2007, the Pan-Canadian Investors Committee (the 'Investors Committee') was formed to oversee the restructuring process. The market freeze was also extended on multiple occasions, allowing the Investors Committee to seek ways to deal with the complexities of re-organising the entire ABCP market.

The restructuring

In March 2008, the efforts of the Investors Committee paid off. A plan was developed to restructure the entire third party ABCP market (the 'Plan'). The Plan was announced to interested investors on 14 March 2008. On 17 March 2008, the Investors Committee sought and obtained protection from the Ontario Superior Court of Justice (the 'Court') under the Companies' Creditors Arrangement Act (the 'CCAA'). Each of the Applicants was a note-holder holding a minimum of USD 1 million of ABCP for which at least one of the Respondents was the debtor. Each of the Respondents was a trustee of an ABCP Conduit with ABCP in excess of USD 5 million. The list of entities comprising the Applicants and Respondents included Canadian chartered banks and Canadian investment houses, as well as foreign banks and financial institutions.

In order for the CCAA to apply, the Conduits had to fall within the definition of 'debtor company' or 'affiliate debtor company'. Those terms do not encompass trust entities. For the purposes of the CCAA filing and proposed Plan, therefore, those entities not qualifying under the CCAA were replaced by companies that did meet the definition. The Court was satisfied that the change in trustees was undertaken in good faith to facilitate the making of the CCAA application.

The Court further permitted the joining of each of the claims within a single proceeding as a result of the unique circumstances. The practicalities of the ABCP crisis required a global implementation of a plan of arrangement. A piecemeal or 'one-off' restructuring

would not have been successful or produce the desired result.

The Court found that each of the Respondents was insolvent as a result of their inability to meet their liabilities to the Applicants as they became due. At the initial hearing, the Applicants put forward the Plan which would restructure the entire affected ABCP market. The Court granted an initial order giving the Conduits the protections afforded under the CCAA. The Court also scheduled a meeting of the note-holders to vote on the Plan and sanctioned the method of notice to be given to the affected note-holders. The Court was also satisfied with the proposal that all creditors be placed into a single class for voting purposes.

The Plan

The Plan was to restructure all third party ABCP, not just that held by the Applicants. Under the Plan, the ABCP would be replaced by longer-term notes which matched the maturity of the underlying assets. This 'matching' was designed to reduce the risk of maturity defaults that had developed in the ABCP market. Further, underlying assets in various note classes would be pooled to enhance the stability of the security. Margin provisions under certain credit swaps were also changed to create renewed stability, thus reducing the likelihood of margin calls. This provision would also reduce the risk that the Conduits would have to post additional assets for the swap obligations or be subject to having their assets liquidated, thereby preserving the value of the assets and the ABCP.

Third party releases

The Plan, as initially proposed, included comprehensive releases of third parties for both negligence and fraud. On the day before the note-holders meeting to vote on the Plan, however, certain note-holders sought relief from the Court, citing concerns about voting classifications and the Plan's inclusion of third party releases. The Court was reluctant to delay the vote and the possible restructuring of the ABCP market. Accordingly, the Court held that the issue of classification and the validity of the third party releases could subsequently be determined as part of the fairness process. It was satisfied that the Monitor would be able to count the votes in such a manner as to deal with the issue of classification at a later date.

The vote proceeded as scheduled. Additionally, just prior to the vote, some dealers made an offer to purchase the paper of certain note-holders who held less than USD 1 million of ABCP. The offer was designed to obtain the necessary number and value of votes to ensure that the Plan would be approved.

The vote was overwhelmingly in favour of the Plan with an approval rating of 96%. When votes were tabulated into two classes comprised of those entities who were involved with the formulation of the Plan and into all other note-holders, those who were involved in the formulation of the Plan voted 99.4% in favour of the Plan and those who were not involved in the formulation of the Plan voted 80.5% in favour of the Plan. Regardless of the classification of the note-holders, the required majority was achieved to approve the Plan.

It appears from the material filed with the Court that the monetary cutoff of USD 1 million eliminated any immediate recovery to some elderly individuals and families holding ABCP through corporations. In some cases, this amounted to their entire family savings. Accordingly, the Court asked the Applicants to consider a hardship consideration process to deal with such note-holders.

Shortly after the vote, the applicants sought approval of the Plan by the Court. The approval was, however, opposed by a number of note-holders. The basis of the opposition to the Plan was that the releases provided for were either beyond the jurisdiction of the Court to sanction or were overly broad and offensive and therefore could not pass the test of being fair and reasonable. The Court adjourned the Plan sanction motion, expressing reservations about the release language encompassed in the Plan. The Court was not satisfied that the proposed release, which was broad enough to encompass release from fraud, was properly authorised by the CCAA or that it was necessarily fair and reasonable. The Court further found that it did not have sufficient facts on which to reach a conclusion. The parties were urged to devise a mechanism which would address any claims based in fraud.

Extensive discussions ensued and amendments to the release language were proposed, creating a 'carve-out' such that certain claims were not precluded by the release language. The carve-out proposal did not, however, satisfy the objecting note-holders.

At the Court's request, the Monitor compiled information which outlined that the primary defendants to any claim for fraud were anticipated to be the banks (and their employees) and dealers, all of which were solvent entities. The information provided by the Monitor also concluded that, due to the likelihood of claims over against other parties, no party involved in the restructuring would likely be spared from involvement in the possible claims. It was further believed that claims against the proposed defendants would primarily be framed in tort and would include negligence, misrepresentation, negligent misrepresentation, failure to act prudently as a dealer/advisor and acting in conflict of interest. Only in a few instances was it expected that claims would be framed in fraud or potential fraud.

It was also made clear to the Court that, if the Plan was rejected on the basis of fairness or lack of jurisdiction, then there was no reliable prospect that the Plan would be further negotiated. The Court was faced with tremendous pressure to approve the Plan with the proposed release language or face a complete meltdown of the ABCP market.

The Plan was designed to benefit all note-holders, not just the Applicant note-holders. It was argued by certain note-holders that they should be exempt from the releases. The Court found, however, that an exemption of any note-holders would ultimately lead to the failure of the Plan, resulting in a further devaluation of the assets underlying the paper. It was noted by the Court that the parties challenging the release language assumed that they would be entitled to mitigate their damages by taking advantage of the Plan without the need to provide the requested releases.

The Court ultimately sanctioned the Plan containing the amended third party releases. In its reasons, the Court noted that the restructuring would only be viable to the Respondents with the input, contribution and direct assistance of the Applicants and those associated with them who would similarly contribute to the Plan. The only way to restructure the ABCP market was to restructure the notes, which could not be done without the input of capital to the Respondents.

The Court's decision was unsuccessfully appealed to the Ontario Court of Appeal. At appeal, it was held that the CCAA permitted the inclusion of third party releases in a plan of compromise or arrangement to be sanctioned by the Court where the releases were reasonably connected to the proposed restructuring. The Court of Appeal's decision was further appealed, but on 19 September 2008, the Supreme Court of Canada refused to grant leave. With the Supreme Court's refusal to hear the appeal and despite harsh criticism, the restructuring of the third party ABCP market in Canada will now be implemented.

Comparison to the US approach

The handling of the ABCP crisis in the United States has been markedly different. In an effort to manage the US ABCP crisis, the Federal Reserve Board (the 'Board') recently created a new program to purchase ABCP directly from eligible issuers through the creation of the Commercial Paper Funding Facility ('CPFF'). This facility is designed to act as a 'liquidity backstop' to provide liquidity to term funding markets and thereby help money funds meet demands for redemption. The Board would provide financing through a special purpose vehicle ('SPV') under the CPFF which would be secured by all of the assets of the SPV.

In contrast to the Canadian approach, this approach requires direct government involvement and

necessitates a shifting of risk on to the government. The restructuring of the Canadian ABCP market did not require any involvement by or funding from the Canadian government.

The restructuring of the third party ABCP market in Canada was completed quickly and effectively. Despite

the controversy over 'buying votes' and granting of sweeping third party releases of solvent entities, the Canadian approach is an example of the flexibility and ingenuity of the Canadian bankruptcy system.