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PROPOSALS UNDER THE BIA[1]

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Reorganizations and Restructuring in Canada

- Typically a solvent corporation does not need to restructure its affairs. It is able to pay its liabilities when due. Its assets have a realizable value greater than its liabilities.

- Usually, insolvency arises out of the inability of a corporation to pay its liabilities when due. Cash flow crises virtually always precede balance sheet insolvencies.

- The essence of a reorganization is that the insolvent corporation requests that its creditors accept something less than what they are owed when due. The insolvent corporation makes an offer to its creditors to compromise their claims against the insolvent corporation. There are no restrictions upon the type of compromise an insolvent corporation can offer to its creditors. It could offer to pay all amounts owing by it – albeit without interest and over time. It could offer to pay less than everything it owes to its creditors whether up front or over time. It could offer to convert all or a portion of its debt into equity.

- An insolvent corporation can restructure its affairs on a private contractual basis. The difficulty in doing so is that all creditors must agree to such a private compromise. Otherwise, the dissenter(s) can take legal proceedings to recover amounts owing to them notwithstanding that the other creditors have accepted a compromise. That creditor would then obtain preferential treatment, and negate the benefits achieved by the compromise with other parties.

- In order to facilitate reorganizations of insolvent corporations, insolvency statutes have been enacted pursuant to which insolvent corporations can reorganize their affairs without the unanimous consent of their creditors. The insolvency statutes in Canada are

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[1] This paper deals with corporate proposals (rather than consumer proposals for individuals) under the BIA.

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federal, with equal application in all provinces, whereas the statutes governing personal property security are provincial.

- An insolvent corporation in Canada can restructure its affairs under the *Companies' Creditors Arrangement Act* (the "CCAA") or the *Bankruptcy and Insolvency Act* (Canada) (the "BIA"). The two statutes are fundamentally different.

- The CCAA provides a framework within which the insolvent corporation has a great deal of flexibility to operate and restructure its affairs. The court is heavily involved at each stage of the proceeding, which therefore results in increased professional costs.

- The BIA contains a comprehensive regulatory regime for reorganizations of insolvent corporations. The statute prescribes the process by which an insolvent corporation can reorganize pursuant to a proposal made to its creditors.

- The BIA has recently undergone a process of comprehensive reform. The current reforms have been pending since the legislation was enacted in 2005, and were proclaimed into force effective September 18, 2009. These amendments incorporate certain additional characteristics of a restructuring proceeding under the CCAA.

Overview

- A restructuring plan to be implemented under the BIA is called a proposal. The effect is no different than a plan of compromise and arrangement under the CCAA, other than being called a proposal. There are no boundaries upon the terms of a proposal.

- A proposal is an offer by a corporation to its creditors to compromise the claims of its creditors in order that the corporation may continue to carry on in business.

- A proposal may provide for the payment of cash, or cash over time, out of net profits, out of gross revenue, out of net available cash flow, for the issuance of shares in the corporation in satisfaction of the debt, or any combination of the foregoing or for any other consideration the corporation can devise.

What is the procedure for making a proposal?

- Unlike a CCAA proceeding, there is no need to apply to Court to commence a restructuring under the BIA. Proceedings may be initiated either by the filing of a proposal, or a notice of intention to make a proposal. Upon the filing of the proposal or the notice of intention, all proceedings against the insolvent corporation are stayed by virtue of the provisions of the BIA.

- A notice of intention to make a proposal must be accompanied by a list of the corporation's creditors that are owed more than $250.00. Within 10 days after filing a notice of intention to make a proposal, the corporation must file a cash flow statement

and a report by the corporation regarding the preparation of the cash flow statement with the Official Receiver.

- The corporation must file a proposal within 30 days after the filing of a notice of intention to make a proposal.

- An insolvent corporation can file a proposal to its creditors with the Official Receiver. The Official Receiver is an officer of the Superintendent in Bankruptcy. The corporation files its proposal together with a resolution of directors authorizing the filing of a proposal and a statement showing the financial position of the corporation.

Extending The Process

- If the insolvent corporation cannot file a proposal within 30 days of filing a Notice of Intention to Make a Proposal, the insolvent corporation can apply to the Court for an Order extending the time for filing a proposal. However, the insolvent corporation must file a proposal within 6 months of commencing the process.

- The BIA provides that the insolvent corporation can obtain an extension of time for filing a proposal if it satisfies the Court that:

  (i) the insolvent corporation has acted and is acting in good faith and with due diligence;

  (ii) the insolvent corporation would likely be able to make a viable proposal if the extension being applied for were granted; and

  (iii) no creditor would be materially prejudiced if the extension being applied for were granted.

Terminating A Proposal Proceeding

- A creditor can apply to the Court for an Order terminating a proposal. If the creditor is successful, the insolvent corporation is immediately assigned into bankruptcy. In such an application, the creditor must satisfy the Court that:

  - the insolvent person has not acted, or is not acting, in good faith and with due diligence;

  - the insolvent person will not likely be able to make a viable proposal;

  - the insolvent person will not likely be able to make a proposal that will be accepted by the creditors;

  - the creditors as a whole would be materially prejudiced if the application was rejected.

- Where the insolvent corporation is seeking an extension, it must satisfy the Court that no creditor would be materially prejudiced. However, if a creditor is seeking to terminate a proposal proceeding, the creditor must establish that the creditors as a whole would be materially prejudiced. As a result, a creditor is better advised to oppose an extension application rather than seeking to terminate an existing proceeding.

What is the effect of a proposal upon the creditors?

- The filing of a proposal or a notice of intention to make a proposal stays all proceedings against the corporation. The stay of proceedings means that no creditor can take any step against the corporation to recover amounts owing to it by the corporation.
- In the case of a secured creditor, it cannot take any steps to enforce its security. The secured creditor cannot notify the corporation's customers to pay their accounts to it as the operating lender. A secured creditor cannot appoint a Receiver or a Receiver and Manager to sell the business as a going concern. If a proposal is filed that does not purport to bind secured creditors, they are not stayed.
- Under the stay, mortgagee cannot take steps to sell real property under its mortgage, to attorn the rents or to foreclose upon the property.
- The purpose of the stay of proceedings is to enable the corporation to safeguard its assets from its creditors while it seeks to develop a proposal.
- The imposition of a stay of proceedings as against secured creditors is a significant encroachment upon their contractual rights. The primary concern secured creditors have is that their security position, particularly with respect to the current assets of the corporation (inventory and accounts receivable), will erode if the corporation operates at a loss while the stay of proceeding is in place. This concern stems from the fact that while the stay of proceedings is in place, the corporation can use its receivables to fund its operations.
- Where the corporation has made arrangements with its operating lender prior to filing a proposal, the stay of proceedings generally does not adversely affect the operating lender. The operating lender will usually obtain a forbearance agreement or a revised loan agreement in order to protect its position.
- A secured lender should obtain legal advice immediately upon learning of the commencement of a proposal proceeding without its prior knowledge and consent.
- The stay of proceedings is extremely broad. A secured creditor could violate the stay of proceedings by, for example, returning cheques, consolidating accounts or setting off credit balances against its secured loan or taking any other steps to enforce its security.
- Legal advice should also be obtained with respect to bringing a motion to terminate the proposal proceeding or granting the secured creditor leave to enforce its security.

Classification of the Creditors

- The proposal can be made to all of the creditors of an insolvent corporation. The insolvent corporation will propose classes of creditors in the proposal itself. If a creditor is dissatisfied with the proposed classes, it may move before the Court for an Order amending the proposed classification.

- Creditors are divided into classes for the purposes of voting on a proposal. Typically, unsecured creditors are placed in one class. Secured creditors may be placed in one or more classes. Secured creditors may be divided into classes according to the nature of their respective debts, the nature and priority of their respective security, the remedies available to them in the absence of the proposal or their treatment under the proposal.

- Typically, a senior creditor or creditors will be placed in a separate class from subordinate secured creditors.

- Secured claims may be included in the same class if the interests of the creditors are sufficiently similar. The BIA test for a "commonality of interest" between creditors takes the following into account:

  - the nature of the debts giving rise to the claims;

  - the nature and priority of the security in respect of the claims;

  - the remedies available to the creditors in the absence of the proposal and the extent to which the creditors would recover their claims by exercising those remedies;

  - the treatment of the claims under the proposal and the extent to which the claims would be paid under the proposal; and

  - such further criteria, consistent with those set out above as are prescribed.

The Claims Process

- Unlike the CCAA, the BIA contains a complete code for proving claims and appeals from disallowances of claims.

Approval of a Proposal

(i) How is a proposal voted upon?

- A majority (in number) of the creditors in each class holding two-thirds in value of the debt voting in the class must vote in favour of a proposal for it to be accepted by the class.
- If a secured class does not approve a proposal, the proposal does not fail. The proposal simply does not bind that secured class. However, if the unsecured creditors do not approve a proposal, the corporation is automatically and immediately assigned into bankruptcy.
- A secured creditor should always try to be in its own class, to ensure that it has a veto over the proposal.

(ii) What is the test for Court approval of a proposal?

- The Court is obligated to hear the report of the Trustee regarding the proposal and the conduct of the debtor.
- The Court is also obligated to hear the Trustee, the corporation and any opposing, objecting or dissenting creditors prior to approving a proposal.
- If the Court is of the opinion that the terms of the proposal are not reasonable or are not calculated to benefit the general body of creditors, the Court will refuse to approve the proposal.
- Additionally, proposals must provide for the payment of claims of workers for outstanding wages immediately after court approval. Under reforms to the BIA enacted in July 2008, unpaid wage claims are made under the *Wage Earners Protection Program Act* (the "WEPP"). The WEPP provides for payment of up to $3,000 per worker for wage and vacation pay arrears as well as severance and termination pay through a fund operated by the federal government. The federal government subrogates the rights of the employees as against the employers for that amount. Workers are protected by a super-priority charge of up to $2,000 per worker for arrears of wages and vacation pay secured on the debtor's current assets.
- As of September 18, 2009, in order to obtain Court approval proposals must provide for the payment of unpaid pension contributions unless the parties to the pension plan have entered into an agreement approved by the relevant pension regulator. In addition, the proposal must also provide for payment in full of arrears for source deductions unless Canada Customs and Revenue Agency otherwise consents. These amounts must be paid within 6 months of the date that the proposal is approved by the Court.

(iii) What is the effect of the Court not approving a proposal?

- If the Court does not approve a proposal, the corporation is deemed to have immediately made an assignment into bankruptcy.

Carrying On Business Under A Proposal

- As is the case under the CCAA, an insolvent corporation that commences a proposal proceeding remains in possession and control of its assets. It continues to carry on business. However, lenders are not obligated to advance further funds, suppliers are not obligated to deliver goods on credit and service providers are not obligated to provide service on credit. Typically, suppliers put the insolvent corporation on cash-on-delivery basis. Any creditor that extends credit to the insolvent corporation after the commencement of a proposal proceeding has no assurance of repayment in the event of a subsequent bankruptcy.

- An operating lender is in the same position with respect to an insolvent corporation under a proposal proceeding as it is in respect of an insolvent corporation under the CCAA. The operating lender is not obligated to advance additional funds. However, the insolvent corporation is entitled to use its receipts to fund its expenses. The operating lender would violate the stay of proceedings if it applied the insolvent corporation's receipts against the operating line of credit.

- As is the case under the CCAA, typically the insolvent corporation makes arrangements with its operating lender for ongoing credit prior to filing a proposal proceeding. On September 18, 2009 the debtor-in-possession ("DIP") financing provisions in the BIA were proclaimed into force. The ability to obtain secured interim financing can be critical under a proposal proceeding, and the reforms set out the criteria for the court ordering such DIP loans, including the requirement of notice on affected secured creditors. The court may grant interim financing and give the lender a charge in priority to existing security interests, but such charge cannot secure pre-existing debts. Additionally, the reforms allow the court to grant charges to secure certain professional fees and court-ordered indemnities of directors who remain on the board during the restructuring. These amendments are consistent with the current practise in proceedings under the CCAA.

- If the borrower has unused availability under its operating line at the time it commences a proposal proceeding, the Bank may advise the borrower that no further advances will be made, unless of course the borrower has made prior arrangements with the Bank as operating lender prior to commencing the proposal proceeding. This will require the borrower to seek a court order requiring the Bank to make such advances available. Legal advice should be obtained in such circumstances.

- As of September 18, 2009 sales of assets outside the ordinary course of business will be permitted with court approval. This is also similar to a restructuring under the CCAA.

Monitoring The Insolvent Corporation

Trustees

- The BIA provides that the insolvent corporation must name a Trustee to act in the proposal. The Trustee must be a licensed Trustee in Bankruptcy. The Trustee cannot be the auditor of the insolvent corporation.

- The BIA provides that the Trustee shall monitor the insolvent corporation's business and financial affairs, shall file a report with the Superintendent in Bankruptcy if there is any material adverse change in the insolvent corporation's projected cash flow or financial circumstances and shall deliver a report to the creditors and the Court in respect of the proposal. The Trustee's report generally contains a recommendation that the creditors vote in favour of the proposal. However, if the Trustee is of the view the creditors would be better off liquidating the insolvent corporation through a bankruptcy, the Trustee will recommend that the creditors reject the proposal.

- The BIA does not provide specific duties for the Trustee to perform. The Trustee is an officer of the Court that owes a duty to both the insolvent corporation and the creditors, and the Trustee must balance the two interests carefully. Particularly, the BIA provides that the Trustee must file a material adverse change report with the Superintendent of Bankruptcy. However, the BIA does not require that the Trustee deliver it to the creditors. Typically, the Trustee would be well advised to tell the insolvent corporation to make disclosure of a material adverse change to the creditors failing which the Trustee will do so or seek the direction of the Court.

Inspectors

- A proposal will provide for the election of up to five inspectors by the creditors. The inspectors provide guidance to the Trustee. Typically, a proposal will provide that the inspectors have the authority to extend the time for the making of payments under the proposal and to either waive a default under the proposal or instruct the Trustee to apply to the Court for an Order annulling the proposal upon the occurrence of an event of default.

- If the Court annuls a proposal after a default occurs, the corporation is immediately bankrupt.

Remedies for default under a commercial proposal

- Where the corporation defaults under the terms of its proposal, the inspectors can either waive the default or instruct the Trustee to bring a motion before the Court to annul the proposal.

- If the Order to annul the proposal is granted, the corporation is immediately deemed to have made an assignment into bankruptcy.