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• IMPORTANCE OF DEBTOR'S GOOD FAITH IN PROPOSAL PROCEEDING •

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Alexander Soutter

INTRODUCTION

In *YSL Residences*,[1] the importance of good faith and transparency in proposal proceedings under the *Bankruptcy and Insolvency Act* (the "***BIA***") was reaffirmed. Where a debtor makes a proposal under the *BIA*, but the Court finds that instead of acting in good faith it engaged in self-interested behaviour, the Court will uphold the *BIA*'s principles and refuse to sanction the proposal.

In that case, Justice Dunphy considered a proposal (the "**Proposal**") by YG Limited Partnership ("**YG LP**") and YSL Residences Inc.[2] There were a number of live issues before the Court, including whether: (a) a general partner can cause a limited partnership to make a proposal over the objections of the limited partners; (b) certain claims were properly characterized as unsecured or equity claims; (c) the debtors' self-interested behaviour leading up to the proposal lacked good faith; and (d) the impact of a nearly unanimous creditor vote in favour of the proposal.

This article reviews those issues and comments on the importance of a debtor's good faith when seeking relief under the *BIA*.

BACKGROUND TO THE YSL PROJECT

The Structure of YG Limited Partnership

YSL Residences involved Toronto's "YSL Project", a condominium project beneficially owned by YG LP via its nominee corporation, YSL Residences Inc. YG LP was formed in 2016 pursuant to the *Partnership*

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Act[3] as a limited partnership between two developers, one being the Cresford Group. Each developer contributed $15 million in exchange for units in the partnership entitling the holder to the ultimate profits of the YSL Project. The general partner of YG LP (the "**GP**") was also part of the Cresford Group.

A member of the Cresford Group bought into YG LP by borrowing its $15 million (the "**Buy-In Loan**"). The Cresford Group later bought-out the other developer, in part by using a further $13 million in borrowed funds (the "**Buy-Out Loan**"). Those borrowings were repaid by other members of the Cresford Group.[4]

Shortly after buying out the other developer, the Cresford Group solicited $14.8 million in investments in YG LP. In exchange for their contributions, these investors took "Class A" units that entitled them to a preferred, but capped, return on their investment.[5] The Cresford Group retained all units in YG LP that were entitled to the residual profits of the YSL Project.

The Cresford Group's Other Projects Become Insolvent

In March 2020, three other condominium projects being developed by the Cresford Group were placed in receivership.[6] This prompted inquiry by the Class A limited partners into the affairs of the partnership, which was not forthcoming. The Class A limited partners even had to resort to obtaining a court order to obtain access to information that should have been available to them as of right.

The Cresford Group Markets the YSL Project

Between March 2020 – April 2021, the GP presented potential transactions to the Class A limited partners. These transactions required the limited partners to compromise on their entitlement while approximately $38 million would be paid to members of the Cresford Group. These transactions failed primarily because the GP was unable to satisfactorily explain why the Cresford Group would receive a substantial payment in priority to the limited partners, given "substantial evidence" that the Cresford Group's entitlement to proceeds of the YSL Project was intended to

be subordinated to the Class A limited partners' entitlement.

During this time, YG LP's first mortgage matured and it negotiated a series of forbearance agreements with its senior secured lender. YG LP defaulted on those forbearance agreements, the lender commenced receivership proceedings, and YG LP bought even more time by way of further forbearance agreements.

Finally, in April 2021, the GP executed an agreement with another developer (the "**Sponsor**") which provided that the Sponsor would sponsor YG LP and YSL Residences Inc.'s Proposal. The basic terms of the Proposal were that the Sponsor would contribute $37.7 million in exchange for taking title to the YSL Project. From the $37.7 million, unsecured creditors would receive up to 58% of their claims. Secured and lien claimants were to be unaffected.

PROCEDURAL HISTORY

In April 2021, the Class A limited partners commenced applications for orders removing the GP from its capacity as general partner and for declarations that the GP had breached its fiduciary duty to the limited partners. The next day, YG LP and YSL Residences Inc. filed a Notice of Intention ("**NOI**") to make a Proposal under the *BIA*. Nearly a month later, the debtors made the Proposal.

Early on, the Cresford Group objected to the Class A limited partners having any standing to participate in the Proposal process or advance their civil applications. Following a June 1, 2021, hearing, Justice Dunphy held that the Class A limited partners' applications ought to be heard together with a proposal sanction motion. That hearing would be effectively the only opportunity for the limited partners to make their case. The Cresford Group's suggestion that the Class A limited partners' concerns be put off until after the proposal proceeding was not an outcome that could not be sanctioned.

MOTION FOR APPROVAL OF THE PROPOSAL

On June 23, 2021, the debtors sought the Court's approval of the Proposal. The Class A limited partners opposed the motion on the basis that: (a) the GP had no capacity to direct the Proposal's filing, whether (i) at law or (ii) pursuant to the YG LP partnership agreement; and (b) the Proposal was not reasonable, calculated to benefit the general body of creditors, or made in good faith.

A. Whether YG LP Could Make the Proposal

The Class A limited partners argued that, since all partners of a general partnership must authorize an assignment in bankruptcy,[7] and the *BIA* applies to limited partnerships "in like manner as if limited partnerships were ordinary partnerships",[8] the GP was not authorized to direct the filing of the Proposal without their consent.

Justice Dunphy declined to follow the case cited by the Class A limited partners[9] and rejected their argument for three reasons:

1. an interpretation of s.85(1) of the *BIA* that required all limited partners to consent to a *BIA* filing would not further the objects of the *BIA* given the impracticality of obtaining such consent on a timely basis;
2. generally, only general partners may bind limited partnerships, suggesting that only the consent of all general partners is required; and
3. *The Partnership Act* provides that actions or suits in relation to a limited partnership may be brought by the general partner(s) as if there were no limited partners. This supported the argument that a general partner could commence a *BIA* proceeding as if there were no limited partners.

The Court also rejected the argument that the GP had no contractual authority to make the Proposal. Though the parties' agreement prohibited the approval of any sale of YG LP's assets without unanimous approval and provided that the GP's insolvency was an event of default, these defaults did not automatically divest the GP with the authority to act on behalf of YG LP.

B. Whether the Proposal Should be Approved

To obtain court approval, a *BIA* proposal must be reasonable, calculated to benefit the general body of

creditors, and made in good faith. Justice Dunphy had concerns with each element of that test, particularly the debtors' good faith. These concerns arose from: (i) the characterization of the Cresford Group's claims as unsecured or equity claims;[10] (ii) the Cresford Group's self-dealing during the process leading up to the Proposal; and (iii) the treatment of certain construction lien claims.

The Cresford Group Claims Were Equity Claims

The Cresford Group advanced an unsecured claim in the Proposal for approximately $38 million, being the amount of the Buy-In Loan, the Buy-Out Loan, and approximately $10 million in interest thereon. The Class A limited partners took the position, and Justice Dunphy accepted, that these claims were better characterized as "equity claims" within the meaning of the *BIA*.

Justice Dunphy held that the *BIA* definition of "equity claim" is not exhaustive and that the term should be given an expansive meaning. Justice Dunphy accepted the following regarding equity claims when attempting to ascertain the true nature of the transaction giving rise to the claim:

1. the subjective intention of the parties (here, the alleged creditors in the Cresford Group and the debtors) is not determinative;
2. the implementation of the transaction and the economic reality of the surrounding circumstances must be examined;
3. it is helpful to consider whether there was a subjective intention to repay principal or interest on the alleged loan from the cash flows of the alleged borrower, and if so, whether that expectation was reasonable; and
4. other relevant factors include whether: (i) there is a maturity date and/or schedule of payments; (ii) there is a fixed rate of interest and schedule of interest payments; (iii) the source of payments comes only from the success of the borrower's business; (iv) security was granted in respect of the advances; and (v) the advances were used to acquire capital assets.

The Court accepted that "clearly advances made or charged to YG LP for the direct or indirect purpose of financing the purchase of an equity interest in YGL are likely, to the point of certainty, to be characterized as equity claims of YG LP for the purposes of insolvency law." Thus, the Buy-In Loan and Buy-Out Loan were characterized as equity claims.

The Cresford Group's "miscellaneous" claims were also accepted as equity claims as they were all non-interest bearing without any defined term or maturity date and there were no loan documents evidencing any of them. Payments were made sporadically and there was no expectation that the advances would be repaid from the cash flow of the YSL Project (there being no expected cash flow until the project was complete).

The result of characterizing the Cresford Group's claims as equity claims meant that the consideration paid by the Sponsor must be considered to be worth $22 million less than it might have been had the related party claims not been equity claims.

The Cresford Group's Self-Interested Conduct Lacked Good Faith

The Class A limited partners took the position that the Proposal was not made in good faith because (a) the GP failed to act in the best interest of the partnership, and instead preferred the interests of the Cresford Group, during the year leading up to the Proposal; and (b) by negotiating and entering into the Proposal Sponsor Agreement the GP deliberately breached the Partnership Agreement. It was argued that all such conduct was a breach of fiduciary duty.

Justice Dunphy accepted it was a breach of fiduciary duty for the GP to have planned and executed a deliberate breach of the Partnership Agreement, particularly in the face of the Class A limited partners' application to stop the GP.

The Court accepted that the GP's fiduciary duties were heightened, not diminished, when YG LP approached insolvency. While nothing prevents a general partner from filing an NOI where, in

good faith it appears to the general partner to be in the best interests of the partnership to do so, this filing was different. The Proposal followed a year of skirmishes between the GP and the Class A limited partners over access to information about YG LP, where the GP squandered "an expensively purchased window of restructuring room" granted pursuant to forbearance agreements with its senior secured lender.

The Court accepted that where a debtor squanders an "expensively purchased window of restructuring room" pursuing the optimal outcome for members of its corporate group (the Cresford Group) and treats those to which it owes fiduciary duties as obstacles, good faith "is not assumed but must be shown." Justice Dunphy was "rather persuasively convinced" that in *YSL Residences*, the debtors' "good faith took a back seat to self-interest."

The Disturbing Unfairness of the Treatment of Lien Claims

One further area of concern surrounded the treatment of creditors with construction lien claims. Under the Proposal, they were to be treated as unaffected creditors. Most of them, however, agreed to assign their claims to the Sponsor if the Proposal was approved, filed *unsecured* proofs of claim, and delivered proxies in favour of a representative of the Sponsor. The Sponsor relied on those proxies to vote in favour of the Proposal. Justice Dunphy found a "particularly disturbing" element of unfairness in these creditors electing to "downshift" their claims from unaffected to unsecured.

C. The Court's Comments on the Creditor Vote

Though more than the requisite double-majority voted in favour of the Proposal, the Court held that the probative value of that vote on the fairness of the proposal was attenuated:

1. only a relatively small minority voted who did not also enter into assignment agreements with the Sponsor;
2. the consideration for such agreements was equivocal, and the Sponsor's denial of any side-deals, without more, did not carry significant weight;
3. if the assigning creditors did stand to receive more than they were to be allocated on paper under the Proposal, their vote says little about their business judgment. Rather, their vote says more about the Sponsor's willingness to pay more than the amount reflected in the Proposal itself; and
4. the evidence on the approval motion was not available to the creditors when they voted.

REVISED PROPOSAL ACCEPTED

The Court refused to approve the Proposal as it failed each element of the test for approval. The Proposal was not reasonable, nor calculated to benefit the general body of creditors, and there were serious issues regarding the good faith with which it was prepared and presented by the debtors. The Court did, however, permit the debtors present a revised proposal.

The revised proposal: (a) treated all lien claimants as unaffected creditors; (b) treated related party claims (ie. the Cresford Group's claims) as equity claims; (c) removed the 58% cap on unsecured recoveries; and (d) provided that any residual of the fixed cash pool would be disbursed in accordance with a direction from all Class A limited partners, or as ordered by the Court.

CONCLUSION AND TAKEAWAYS

YSL Residences also supports a view that the good faith of conduct leading up to the formal filing of an insolvency proceeding can be considered where:

1. the impugned conduct is connected to the proceeding (in this case, the Cresford Group's self-interested attempts at marketing the YSL Project culminated in the Proposal); or
2. the debtor is already subject to insolvency proceedings (here, YG LP's senior secured

lender had formally commenced its receivership application in October 2020).

This look-back period is consistent with *CWB Maxium*,[11] and *Wang (Re)*.[12] *CWB Maxium* dealt with a challenge to a secured creditor's good faith in bringing a receivership application. Justice Mah accepted that while one should not reach back into time indefinitely when assessing good faith conduct, it was appropriate in that case to assess the secured creditor's conduct as far back as the prospect of their receivership proceeding first materialized. In that case, it was when demand letters were sent.[13]

In *Wang (Re)*, the debtor was the principal of several corporations that had obtained protection under the *CCAA*,[14] and of other corporations that had not sought creditor protection referred to as "Non-Applicants". Both groups of companies were subject to orders made in the *CCAA* proceeding, including an order that the proceeds of the sale of assets of those companies be held in trust by the *CCAA* monitor. A creditor of one such company, and of the debtor, brought a motion to terminate the time for the debtor to make a proposal pursuant to s.50.4 of the *BIA* after he filed an NOI. Justice Hainey accepted that the debtor failed to act in good faith by engaging in impugned conduct both *before* and after filing his NOI. The pre-NOI conduct that lacked good faith was all connected to the debtor's conduct in the *CCAA* proceeding.

Ensuring the fairness and reasonableness of a compromise imposed pursuant to insolvency proceedings is a gatekeeper role guarded by the Court, even where an overwhelming majority of creditors approve of the compromise. That was evident in *YSL Residences* (where there was unanimous creditor approval) and in *CannTrust*,[15] where a plan under the *Companies' Creditors Arrangement Act* was found not to be fair and reasonable despite creditor approval.

Proposals under the *BIA* are an effective restructuring tool. Courts will be careful, however, to ensure that the integrity of the bankruptcy process is upheld. On a fundamental level, that process requires certain baseline standards of good faith. Where there are issues as to the debtor's good faith, particularly if the spectre of self-interested dealing becomes apparent, the Court will dig into the conduct of the parties and concern itself with both the fairness of the proposal and the fairness of the process leading to the proposal.

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1 *YG Limited Partnership and YSL Residences (Re)*, 2021 ONSC 4178 [*YSL Residences*].

2 The proposal proceedings by these debtors were procedurally and substantively consolidated by earlier order.

3 *The Partnership Act*, CCSM c P30.

4 In the Proposal, the Cresford Group claimed to be an unsecured creditor for the $15 million buy-in, the $13 million buy-out of the other developer, plus nearly $10 million in interest.

5 When making these advances, the Class A limited partners were told by representatives of the Cresford Group that the proceeds of the YSL Project would be distributed to them ahead of any amount going to the Cresford Group.

6 *BCIMC Construction Fund Corporation et al v The Clover on Yonge Inc*, 2020 ONSC 1953.

7 *Squires Brothers, Re*, [1922] WWR 130 (SKQB).

8 *BIA*, s.85(1).

9 *Aquaculture component Plant V Limited Partnership (Re)*, 1995 CanLII 9324 (NSSC).

10 The Court rejected the Cresford Group's suggestion that that question should be left for another day, both because it would have a significant impact on the reasonableness of the proposal, and because the conclusion affected the determination of the debtors' good faith.

11 *CWB Maximum Financial Inc v 2026998 Alberta Ltd*, 2021 ABQB 137 [*CWB Maxium*].

12 *Wang (Re)* (unreported, 15 April 2020), Toronto 31-2610052 (ONSC Commercial List).

13 *CWB Maxium* at para 49.

[14] *Companies' Creditors Protection Act*, RSC 1985, c C-36 [*CCAA*].

[15] *CannTrust Holdings Inc, et al (Re)*, 2021 ONSC 4408

• UNEQUAL TREATMENT OF CREDITORS: PAYING A SUPPLIER'S PRE-FILING DEBT IN A PROPOSAL UNDER THE *BANKRUPTCY AND INSOLVENCY ACT* •

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Wojtek Jaskiewicz

Section 11.4 of the *Companies' Creditors Arrangement Act*, RSC 1985, c C-36 ("***CCAA***"), gives the Court the power to order a supplier to continue to supply to an insolvent company. The *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 ("***BIA***") does not have any similar provisions. The *BIA* has provisions that prevent a supplier from terminating an existing contract, but if there is no existing contract requiring the supplier to continue supplying, the Court cannot force the supplier to do anything.

DOES THIS MEAN THERE ARE NO OPTIONS LEFT FOR A CREDITOR THAT NEEDS TO KEEP ITS RELATIONSHIP WITH ITS SUPPLIER?

We were faced with this problem recently. A company approached us to assist with its restructuring. The client did not have claims totaling more than $5 million, so the *CCAA* was not an option. The restructuring would have to be done under the *BIA*.

Our client's problem was that its largest unsecured creditor was also its main supplier. Approximately 80% of the client's business depended on the products supplied by this supplier. This would not be a problem if the client and the supplier had an ongoing agreement to continue to supply, but there was no such agreement. The supplier could cut our client off at any time and had no legal obligation to continue to accept our client's business.

To be successful after the restructuring, the client needed continued supply from the supplier, ideally on favorable credit terms.

We hoped to negotiate favourable payment terms with the supplier. Instead, the supplier told us that if its pre-filing debt was not paid in full, it would not supply, even on a cash on delivery basis.

Clearly the supplier was a critical supplier in every sense of the word. Without the supplier, there was no business.

We were faced with what seemed like an impossible task – negotiate favourable payment terms with a supplier demanding payment of all its pre-filing debt. And we delivered just that – an agreement with the supplier to provide payment terms together with a proposal, approved by the

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creditors and the court, which paid all the supplier's prefiling debt.

BUT HOW COULD THE SUPPLIER BE PAID ALL OF ITS PRE-FILING DEBT?

A basic tenet of the *BIA* and insolvency legislation in general is that all unsecured creditors are supposed to be treated equally. Sections 95 and 96 of the *BIA* deal with preferences and transfers at undervalue. These sections are designed to prevent unequal treatment of creditors and to unwind transactions that offend this principle.

However, there are two cases - one from the Ontario Court of Appeal and the other from the Supreme Court of British Columbia - which say that treating unsecured creditors equally is the norm, but it is not always necessary or advisable.

In *Contech Enterprises Inc.* (Re), 2015 BCSC 129, the Court approved a proposal that provided for additional recovery for certain creditors that the debtor considered to be "key suppliers". The product that the key supplier supplied accounted for approximately 25 per cent of the debtor's annual sales. If the key supplier refused to continue to supply products, it was unlikely that the debtor could continue to carry on business. The key suppliers would receive this additional amount if they first agreed to continue to supply product to the debtor on terms acceptable to the debtor.

In *1732427 Ontario Inc. v 1787930 Ontario Inc.*, 2019 ONCA 947 ("***173 Ontario Inc.***") the Ontario Court of Appeal held that a debtor and a creditor could enter into an agreement for the payment of past debts in order to secure future supply. The Court said that denying a debtor this ability would undermine attempts to successfully reorganize as a going concern. Creditors and debtors alike benefit from the debtor's continued operations. The goal of the stay and preference provisions of the *BIA* is to give the debtor some breathing room to reorganize. Legitimate agreements with key suppliers also form a vital part of that process.

With the legal framework in place, we prepared a proposal which would pay 100% to the supplier and a much smaller dividend to the remaining unsecured creditors.

The creditors were placed into two separate classes – the supplier in its own class and the remaining unsecured creditors in their own class. This ensured that the remaining unsecured creditors would not be "swamped" by the much larger supplier and had the opportunity to independently approve the proposal.

The remaining unsecured creditors recognized that while there was a certain unfairness in the proposal, the supplier held all the cards. If the supplier stopped supplying, the distribution to all creditors would be even lower. While agreeing to a 100 per cent payment to the supplier must have been a hard pill to swallow, it was better than the alternative, and they accepted the proposal.

On June 30, 2021, Master Jean (as she then was) approved the proposal. Master Jean initially expressed concerns that the terms of the proposal were not reasonable or were not calculated to benefit the general body of creditors. However, after hearing submissions, Master Jean was satisfied that the terms of the proposal seeking to provide for 100% of the pre-proposal debt to the supplier is a legitimate agreement with a key supplier which is a vital part of the proposal process and is permitted under the authority of the decision in *173 Ontario Inc*.

THE KEY TAKEAWAY IS THAT IN A PROPOSAL UNDER THE BIA, A DEBTOR CAN PAY MORE TO ONE CREDITOR IF:

1. the creditor is a major supplier;
2. no one else can realistically supply to the debtor;
3. without the supply the debtor is unlikely to succeed post proposal; and
4. the supplier agrees to continue to supply to the debtor on terms that are favourable to the debtor.

The court will approve a proposal where one creditor is paid more than others if paying that creditor more is the only way to create value for all other creditors.

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