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COVID-19: POTENTIAL SOLUTIONS FOR INSOLVENCY SITUATIONS

Introduction - Where to start?

The COVID-19 pandemic has created an economic climate of extreme uncertainty, especially because of the deep interconnected nature of the economy. For example, a shut down of one commercial sector creates a supply chain failure, which results in a lack of sales, leading to lost revenue, defaults under contracts and leases, and potential solvency issues throughout the web of businesses. The pressure your commercial enterprise may be experiencing may not be your fault. Is the business viable in the future but just needs some breathing room to survive this short-term crisis? Can value be preserved through an informal or a formal restructuring arrangement with creditors? What are the options? In this article, we want to describe some possible solutions for companies which may be experiencing solvency concerns.[1]

The most logical place to start is usually by having discussions with creditors and stakeholders to see what, if anything, can be arranged through consensual or informal arrangements. For those discussions to be as productive as possible, they are best undertaken with the benefit of an understanding of formal insolvency proceedings which may be available, as well as steps that might be taken by creditors and claimants to enforce their rights.

As a preliminary consideration, it is important to understand whether the company is insolvent or not. Cash flow insolvency exists when obligations are not being met as they generally become due. Balance sheet insolvency exists when the fair value of the assets if sold would not be sufficient to enable payment of the obligations or liabilities. If either or both situations apply, and $1000 is owing, the corporation is insolvent (*Bankruptcy and Insolvency Act*, RSC 1985, c B-3, *"BIA"*, s. 2). Further, insolvency is not the same as bankruptcy. Bankruptcy is the state of being bankrupt or the fact of becoming bankrupt and that is a formal legal status that companies (or individuals) obtain upon either an assignment in bankruptcy, or a bankruptcy order being made (*BIA* s. 2).

What if the Company Does Nothing: Receivership?

If a company has granted security in real and/or personal property to one or more creditors by agreement (e.g. first secured/lien lenders or real property mortgagees, second secured/lien lenders, or secured bondholders), then, upon a default in payment (or breach of the security or other

[1] Please note that while this article is focused on insolvent companies, much of its content, including reference to NOI (as defined below) proceedings, is applicable to individuals, with the exception of comments about the *CCAA* (as defined below) which are only applicable to corporations.

agreements), those creditors often have the right to enforce their security. One enforcement right commonly available to a secured creditor is the appointment of a receiver, with a view to liquidating, or managing and then liquidating, the assets of a company ("Receiver").

Prior to the appointment of a Receiver, a secured creditor which has a right to enforce a security in respect of all or substantially of the inventory, accounts receivable, or other property of an insolvent must send a notice of that intention, giving the insolvent a minimum of 10-days advance notice before specific steps can be taken by the secured creditor ("Notice") (*BIA* s. 244(1)), unless the insolvent consents to earlier enforcement (*BIA* s. 244(2)). The Notice is designed to provide the insolvent company with prior warning that the creditor is seeking to enforce its security so that the insolvent has some time to potentially respond by taking steps of its own.

Ideally, a company will be well aware that it has breached, or is about to breach, its obligations to a secured creditor, that a Notice may be forthcoming, and is therefore acting pro-actively. However, given the extreme uncertainty caused by the pandemic, this may not be the case. If you receive a Notice, quick action is necessary if an attempt to preserve the business is to have the best chance of success.

Following are some ideas as to what steps you may wish to take when encountering solvency issues, including before, or upon receipt of, any Notice.

"Out of Court" or Informal Arrangements with Creditors

The starting point is generally to speak with the main creditors before commencing any formal insolvency proceeding. Successfully entering into informal consensual agreements or arrangements with creditors is usually a lower cost approach and avoids the oversight of a court officer.

Talk to your creditors and counterparties (including financiers, landlords, mortgagees, and suppliers) to see what might be arranged. But beware — it is an act of bankruptcy to make an admission in writing at a meeting of one's creditors of an inability to pay debts (*BIA* s. 42(1)(f)). That may give your creditors a way to commence unwelcome bankruptcy or other proceedings which might otherwise be unavailable.

Every organization and individual has been drastically affected by COVID-19. The Bank of Canada has dropped the overnight rate three times in 2020 reducing it from 1.75% to 0.25% — where it currently sits as of May 1. The big five Canadian banks, as well as ATB Financial, have dropped their prime rates to 2.45% (also as of May 1). Efforts to renegotiate applicable interest rates, obtain blended rates and/or extend terms are possible areas for discussion. Whether such efforts will meet with success will, of course, depend on many factors.

Where the major concern is the first secured creditor, a forbearance agreement may be a suitable option. In this type of agreement, a creditor agrees to refrain from exercising certain rights in order to allow the debtor company to work toward realizing a common goal. It can be a useful approach to avoid the immediate liquidation of assets through, for example, a receivership. However, it should also be noted that the current economic environment may disincentivize a creditor from taking enforcement steps as the prospects of fully recovering debt may be very limited.

A forbearance agreement may be used, for example, to have a creditor agree to stop requiring interest payments for a period or to tolerate contractual defaults in order to offer the company more time to right the ship, provided milestones are met. The time bought under a forbearance agreement could be used by the corporation to attempt to renegotiate contracts, find an equity investor, or to sell the business in a process where the company and its current directors (and often ownership) are in control. However, as part of a forbearance agreement, a secured creditor will likely require that any arrangement be conditional upon a sale of the business by a certain date or consent by the company to the appointment of a receiver if milestones are not met.

If the situation is more complicated because of the complexity of the business' financing structure (as well as other factors) and an arrangement with numerous creditors is necessary, negotiations could be attempted but success is often more difficult to achieve. The more creditors you need to come to an agreement, the more cumbersome and challenging it can be — often a restructuring filing is necessary.

Formal Court Supervised Restructuring Proceedings

If informal negotiations are not fruitful, more formal restructuring processes, namely, *Companies' Creditors Arrangement Act*, RSC 1985, c C-65 ("*CCAA*") and *BIA* Notice of Intention to Make a Proposal ("NOI") proceedings may be available.

CCAA and NOI Similarities

In both NOI and *CCAA* proceedings, the insolvent debtor remains in possession of the business and is not displaced by a Receiver. The company's directors continue to be responsible for the affairs of the company. However, in both proceedings, they act under the supervision of licensed officers of the court who have relevant expertise: in a *CCAA*, it is a Court appointed monitor (*CCAA* s. 11.7(1)); under an NOI, it is a proposal trustee (*BIA* s. 50.4(7)) (each, a "Court Officer").

In general terms, the Court Officer independently oversees, and reports to the creditors and the Court regarding, the business during the restructuring process. The importance of a Court Officer to each restructuring process and the need for their involvement is part of the reason formal insolvency proceedings can involve significant cost.

A formal *CCAA* or NOI proceeding offers benefits to companies attempting to restructure, including the powerful stay of proceedings ("Stay") which affords valuable breathing room to the insolvent company by putting a stop to most enforcement of rights by creditors and others such that performance by the company's counterparties of most contracts is continued and required.

In addition to the Stay, there many other tools available to a restructuring insolvent company in *CCAA* or NOI proceedings. Our article "COVID-19 And Insolvency Law: What You Should Know" explains the Stay and some of the related tools. Here are some additional ones to take note of:

> DIP Financing - Under both proceedings, after considering all relevant factors, the insolvent company may be allowed by the Court to obtain new interim, or "debtor-in-possession" ("DIP"), financing to facilitate the restructuring (*CCAA* s. 11.2(1); *BIA* s. 50.6(1)). Restructurings can be

capital intensive and advanced planning is necessary to assess whether DIP financing will be required and to make arrangements for it. In exchange for granting DIP financing, the DIP lender will be granted a security over all, or part, of the insolvent's property. The Court may order that the charge or security will take priority over any other existing secured or other claims (*CCAA* s. 11.2(2); *BIA* s. 50.6(3)).

Indemnification of Directors or Officers - To encourage directors and officers to continue in their roles during a restructuring, both insolvency statutes allow the Court to make an order declaring that at least part of the property of the insolvent company is subject to a charge or security, in any amount the Court considers appropriate, to indemnify directors or officers against obligations and liabilities that may arise after either a *CCAA* proceeding begins or an NOI is filed (*CCAA* s. 11.51(1); *BIA* s. 64.1(1)). The Court may order that this charge or security will take priority over any other existing secured or other claims (*CCAA* s. 11.51(2); *BIA* s. 64.1(2)). The Court must order that such a charge or security shall not apply if any obligation or liability that arose was due to the gross negligence or wilful misconduct of a director or officer (*CCAA* s. 11.51(4); *BIA* s. 64.1(4)).

Assignment of Contracts - Both insolvency proceedings allow for the Court to assign many types of the debtor company's contracts to those who agree to take them after considering various factors, including the appropriateness of the assignment (*CCAA* s. 11.3; *BIA* ss. 66 (1), (1.1) and 84.1).

Sale of all Assets - Upon Court authorization, under both a *CCAA* and an NOI proceeding, a debtor company may enter into the sale or disposition of its property without the need for shareholder approval (*CCAA* s. 36; *BIA* s. 65.13).

Both types of restructuring proceedings are aimed at the insolvent debtor making a proposal under the *BIA* ("Proposal") or presenting a *CCAA* plan of arrangement ("Plan"), as the case may be, to some or all of its creditors and claimants, effecting a compromise of their claims. The objective is to have those affected accept a Proposal or Plan which is better for their interests than an immediate liquidation or bankruptcy that the company would otherwise face.

The Proposal or Plan must be approved by the vote of a majority in number of affected creditors in each class holding at least two-thirds of the total value of debt in each affected class (*CCAA* s. 6(1); *BIA* s. 54(2)(d)). After such double majority approval, the Proposal or Plan must be presented to the Court for approval (*CCAA* s. 6(1); *BIA* s. 58) and, if granted, will be implemented.

Which Fits - CCAA or NOI Proceedings?

CCAA - Minimum Debt Requirement - *CCAA* protection is not available to all insolvent companies: to qualify to seek it, an insolvent company must have at least $5 million in debt (*CCAA* s. 3(1)).

CCAA - No Automatic Stay; More Costly - An insolvent company must make an application to the Court requesting a Stay which, if granted, will initially last for no more than a maximum of

10 days (*CCAA* s. 11.02(1)). In order for the initial Stay to be extended, a further Court application is required which, if granted, can allow the Stay to be extended for any length of time the Court thinks is necessary, bearing in mind the objectives of the *CCAA* and interests of affected parties (*CCAA* s. 11.02(2)). The need to bring two Court applications and prepare the related evidence, including from the Court Officer, in order to obtain the benefit of an extended Stay can involve significant cost.

CCAA - Flexible and No Plan Deadline - *CCAA* proceedings are extremely flexible; there is no requirement that the restructuring occur within a set period of time — the Stay can be extended indefinitely, if appropriate. This is an important feature as completing a complex restructuring often requires significant time.

NOI - No Minimum Debt Requirement - In contrast to a *CCAA* proceeding, under the NOI provisions, an insolvent company need not meet any minimum debt requirement.

NOI - Automatic 30-Day Stay - For a *BIA* restructuring proceeding to be started to obtain the benefit of a Stay, an insolvent company need only file an NOI with the official receiver in the insolvent's locality (*BIA* ss. 50.4(1) and (8) and 69). Upon doing so, a 30-day Stay is automatically granted (where further extensions of time can be sought of the Court) (*BIA* s. 50.4(9)). Unlike the *CCAA* process, there is no need to apply to the Court to obtain an initial 10-day Stay and return to Court for a further extension to obtain the benefit of a 30-day Stay. This can be a very important advantage, especially if the company has been caught off-guard by a Notice and is not able to organize its affairs in time to seek *CCAA* protection; it can also save costs by avoiding the need to make Court applications to obtain the Stay.

NOI - 6-Month Proposal Deadline - A limitation of the NOI process is that a Proposal must be filed, accepted, and completed within six months of the NOI filing or the company will automatically be deemed to have made an assignment in bankruptcy (*BIA* s. 50.4(8)). Because of this deadline, the NOI process is often ideal for more straightforward restructurings.

Best of Both Worlds - NOI and then CCAA

It may be possible to obtain the best of both worlds by beginning the restructuring with an NOI filing and then converting it to a *CCAA* proceeding (the reverse is not possible) (*CCAA* s. 11.6; *BIA* s. 66(2)). Of course, the insolvent company must meet the $5-million debt threshold applicable to *CCAA* restructurings for this to be a possibility. This approach could be useful if more than six months was needed for a restructuring to be completed, or if a Notice had been received and there was a rush where insufficient time was available within which to seek a *CCAA* order so as to avoid the otherwise imminent appointment of a Receiver.

Creditors' Rights in a *CCAA* or NOI Proceeding

A debtor does not have *carte blanche* once it has the benefit of a Stay. It must return to Court to demonstrate that it has acted and is acting in good faith and with due diligence, among other things, for the Stay to be extended (*CCAA* ss. 11.02(2) and (3); *BIA* s. 50.4(9)). If the Court were to find that a

CCAA Plan is "doomed to fail" or that an NOI Proposal is unlikely to be viable — which might occur if the fulcrum creditor would not support any Plan or Proposal — the restructuring proceeding can come to an end (in the NOI process it will result in bankruptcy; whereas in the *CCAA* process, it usually results in the appointment of a Receiver). Also, during the currency of a Stay, a creditor or claimant can apply to the Court to lift, or end, the Stay where material prejudice is being experienced or it would be equitable to do so (*BIA* s. 69.4; *CCAA* caselaw).

Conclusion - What to do now?

There are multiple options available to distressed companies within and outside of a formal restructuring proceeding. Each company's situation is unique and may require a different approach. Obtaining early strategic input may positively affect prospects of a successful outcome. Whatever the size of the company and no matter the circumstances, we, at JSS Barristers, have significant insolvency and restructuring expertise across many business sectors and are available to help you navigate your way through these most uncertain times.

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