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VANQUISHER OR VANQUISHED? INSOLVENCY LAW'S POWER TO END CONTRACTS

In our article *COVID-19 and Insolvency Law: What You Should Know*, we touched on the ability of an insolvent company that has made a formal insolvency filing (the "Insolvent Party") to possibly put an end to, resiliate or "disclaim", certain types of contracts.[1]

Why are many contracts permitted to be disclaimed by the Insolvent Party? In the context of a restructuring, the rationale is to permit the Insolvent Party to rid itself of most types of uneconomic or unprofitable contracts which would otherwise negatively affect its ability to restructure. It is also possible for a receiver appointed under the *Bankruptcy and Insolvency Act* ("Receiver" and "BIA," respectively) or a bankruptcy trustee appointed pursuant to the *BIA* ("Trustee") to disclaim certain types of contracts. The rationale in these contexts is to allow the Receiver or Trustee to more efficiently realize on or manage the insolvent's assets for the benefit of its stakeholders.

The economic crisis resulting from the COVID-19 pandemic has meant that some contracts which were previously viable, may not be viable anymore - making disclaimer an attractive right. If you are hoping to successfully disclaim a contract as an Insolvent Party, you may feel like a vanquisher; if you are a solvent counterparty on the receiving end of a disclaimer notice, you may feel as though you have been vanquished.

Whether you intend to disclaim certain contracts as the Insolvent Party, or you are a counterparty to an Insolvent Party (or an insolvent entity over whose property a Receiver or Trustee has been appointed), it is important to understand that not all contracts can be disclaimed. In this article, we will discuss the types of contracts that can be disclaimed; those that can't; and the processes by which disclaimer can occur.

Disclaimer - No

Some types of contracts, including eligible financial contracts ("EFCs"), cannot be disclaimed. Common in the energy sector under both the *BIA* and *Companies' Creditors Arrangement Act* ("*CCAA*"), EFCs are a category of financial contracts that are specifically excepted from being disclaimed. The underlying policy reason EFCs cannot be disclaimed is that legal certainty regarding those particular financial contracts is required to preserve the efficacy of capital markets.

[1] In our article, *Are Contracts Enforceable Despite COVID-19? [Part 7]: Contract Law Meets Insolvency Law - Some Strategic Considerations*, we explained how contractual force majeure or frustration rights may interact with the disclaimer right under insolvency law, as well as some strategic considerations.

EFCs are defined in both the *Eligible Financial Contracts Regulations* (*CCAA*), SOR/2007-257, and the *Eligible Financial Contracts Regulations* (*BIA*), SOR/2007-256. They include:

- Derivative agreements that trade on a futures or options;
- Derivative agreements that are the subject of recurrent dealings in the derivatives markets;
- Agreements to borrow or lend securities or commodities;
- Agreements to clear or settle securities, futures, options or derivative transactions;
- Master agreements, guarantees, or agreements relating to financial collateral including respecting the types of agreements listed above.

Despite the detailed description of EFCs in the *BIA* and *CCAA*'s Regulations, the issue of whether or not a contract qualifies as an EFC is not always clear. As such, it is vital that you carefully consider your contract's eligibility for disclaimer before strategizing on the assumption that you have the ability to claim it.

Other types of contracts that may not be disclaimed in insolvency proceedings include the following where the reason for the exclusion is also noted:

- Agreements through which the Insolvent Party grants another party the right to use intellectual property (*BIA* s. 72.1(2); *CCAA* s. 32(6)) where the exception is to preserve the particular property rights created through such agreements;
- Collective agreements (*BIA* s. 65.11(10); *CCAA* s. 32(9)), based on the interest in protecting and balancing the rights of certain employees where their employer is undergoing restructuring;
- Financing agreements if the Insolvent Party is a borrower (*BIA* s. 65.11(10); *CCAA* s. 32(9)), on the basis that a borrower may be permitted to compromise or restructure its debt obligations, but is not permitted to shed them entirely; and
- Leases "of real property or of an immovable" if the Insolvent Party is the lessor (landlord) (*BIA* s. 65.11(10); *CCAA* s. 32(9)), to protect the interests of tenants.

Disclaimer - Yes

A wide range of contracts are eligible to be disclaimed by an Insolvent Party (or by a Receiver or Trustee, as applicable). If you are considering this option and the contract at issue is not one of those listed above, it is likely that it can be disclaimed. The sorts of contracts that can be disclaimed include supply and service contracts, and leases, as long as the Insolvent Party is the lessee (tenant), rather than the lessor.

If you are an Insolvent Party - the "vanquisher" - the ability to disclaim an uneconomic contract could provide far-reaching benefits to your ability to restructure. On the other hand, if you are a

counterparty to such a disclaimed contract - the “vanquished” - the fact that insolvency law has affected your contractual rights might come as a surprise.

How it Works - *CCAA* and *NOI*

The *CCAA* explicitly recognizes the ability of an Insolvent Party to disclaim a contract (s. 32). The *BIA* similarly recognizes this right in the context of a Notice of Intention to Make a Proposal (“NOI”) (s. 65.11(1)). Both types of restructuring proceedings require that the Insolvent Party act under the supervision of an officer of the Court (a monitor in the case of *CCAA* proceedings, or a proposal trustee under an NOI), each of whom have a role in relation to the disclaiming of contracts.

A counterparty to a contract with an Insolvent Party that is the subject of an intended disclaimer is not without some protection:

> *CCAA* - The *CCAA* requires that the Insolvent Party give notice to other parties to an agreement, and the monitor, and obtain approval of the monitor in order to disclaim a contract (s. 32(1)). If the monitor does not approve the disclaimer, or a counterparty objects, the Court will be called upon to determine whether the disclaimer should be permitted and will consider: whether the monitor “approved the proposed resiliation or disclaimer;" whether it would “enhance the prospects of a viable compromise or arrangement being made in respect of the company”; and whether it would “likely cause significant financial hardship to a party to the agreement” (collectively, the “Factors”) (s. 32(4)).
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> NOI - An Insolvent Party that has filed an NOI may disclaim an agreement on notice to the other parties to the agreement and the proposal trustee (*BIA* s. 65.11 (1)). If a counterparty objects or the proposal trustee does not approve the proposed disclaimer, the Insolvent Party may apply to the Court for an order that the agreement be resiliated or disclaimed (*BIA* s. 65.11(3) and (4)). Again, the Court will have regard to the Factors in determining whether to approve the disclaimer.

If a contract is disclaimed within *CCAA* or NOI proceedings, the Insolvent Party’s contractual counterparty - the "vanquished" - is often left with a (likely unsecured) claim for damages resulting from the breach of contract. Unsecured creditors are paid subsequent to the payment of secured claims and, as such, there are often insufficient funds to satisfy them.

How it Works - Trustees and Receivers Appointed pursuant to the BIA

The *BIA* does not contain provisions explicitly permitting a Receiver or Trustee to disclaim a contract. Instead, the ability to disclaim a contract within such *BIA* proceedings has been recognized at common law by Courts across Canada. If the contract that a Trustee or Receiver seeks to disclaim is determined to be a “material” contract, then leave from the Court must be obtained before it can be disclaimed. It is at this stage that the counterparty may object to being vanquished, so to speak, on the basis that the contract at issue either cannot be disclaimed because it falls within one of the exceptions listed above or, conceivably, on grounds analogous to the Factors.

If a contract is disclaimed in receivership or bankruptcy proceedings, it may place the counterparty to the contract in an unfortunate position. While the insolvent remains liable for damages resulting from the contract being "broken", as in *CCAA* or NOI proceedings, the vanquished counterparty is left with a mere claim for damages which is typically an unsecured one.

What to Do?

If you are considering initiating insolvency proceedings, or are a counterparty to an Insolvent Party, our articles *COVID-19 and Insolvency Law: What You Should Know* and *COVID-19: Potential Solutions for Insolvency Situations* provide an overview of insolvency law and solutions that may be available to you. Our articles are not intended to replace the need for legal advice that is specific to your situation and the contracts and other factors at issue. We, at JSS Barristers, have significant experience in the area of insolvency and restructuring involving companies of all sizes across a number of business sectors, and are available to advise you of your options during this time of economic uncertainty.

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