

**THE REMEDY OF SUBSTANTIVE CONSOLIDATION
UNDER THE COMPANIES' CREDITORS ARRANGEMENT ACT:
A CLOSER EXAMINATION OF DOMESTIC AND CROSS-BORDER ISSUES**

by

Helen Mary Emma Sevenoaks

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ABSTRACT

This thesis is a study on the remedy of substantive consolidation under Canada's primary restructuring statute, the *Companies' Creditors Arrangement Act* ("CCAA"). The objectives of the research are (i) to gain a deeper understanding of how substantive consolidation has evolved under the CCAA, (ii) to investigate whether the current legal landscape provides the most appropriate framework for dealing with the key issues relating to substantive consolidation in both the domestic and cross-border context, and (iii) consider how, if necessary, the position could be improved. The key issues that are the focus of this study are: (a) the factors supporting substantive consolidation, (b) the effect of substantive consolidation and (c) multiple issues relating to the application for an order such as persons permitted to apply, timing on an application, inclusion of a solvent group member and notice.

The doctrinal analysis of the existing jurisprudence suggests there is a failure to carefully consider these key issues in depth. The judicial dialogue solely focuses on the factors supporting consolidation in the domestic context. There is little, if any, guidance on the issues that stem from an application for substantive consolidation or the various effects substantive consolidation can have on creditors' rights. Further, the use of substantive consolidation under the CCAA cross-border framework has yet to be considered at all.

Therefore, this study looks towards the recent work of the United Nations Commission on International Trade Law Working Group V (Insolvency Law) on substantive consolidation in order to propose an array of policy options for the use of the remedy under the CCAA. In doing so, the study takes into account the scope of the CCAA, the balance between the need for flexibility and the demand for certainty in CCAA proceedings, what is desirable in practice and the nature of cross-border restructuring proceedings.

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Chapter 1: Introduction

In Canada, it is a common occurrence for businesses to operate in enterprise groups.¹ These structures can result in various operational and financial benefits for the business as a whole.² Yet, in the case of severe financial distress or underperformance enterprise groups can demand restructuring solutions that facilitate a swift recovery but also maximise value *en bloc*. The need to rescue the enterprise group drives many to seek protection from the *Companies' Creditors Arrangement Act*³ that enables financially troubled debtors the opportunity to restructure their affairs by developing a formal plan of compromise or arrangement with its creditors.

However, despite the stark reality of enterprise groups, their restructuring can be both problematic and challenging in the current legal landscape. In Canada, corporations are considered distinct, each being a separate legal entity.⁴ Hence, the restructuring of the enterprise group is not expressly recognised under the *CCAA*. Nevertheless, in recent years the Canadian courts have been active in developing solutions to overcome the difficulties faced by insolvent members of an enterprise group. The sole focus of this thesis is the development and application

¹ Enterprise groups are defined as “two or more enterprises that are interconnected by control or significant ownership.” The term “control” refers to “the capacity to determine, directly or indirectly, the operating and financial policies of an enterprise.” These definitions are those endorsed in the *United Nations Commission on International Trade Law Legislative Guide on Insolvency Law, Part Three; Treatment of Enterprise Groups in Insolvency*, pre-release, July 2010: <http://www.UNCITRAL.org/pdf/english/texts/insolven/pre-leg-guide-part-three.pdf>, paragraph 4, [hereinafter, the UNCITRAL Legislative Guide on Insolvency Law, Part Three; Treatment of Enterprise Groups in Insolvency]. For a more in depth discussion on the definitions used for this project see Chapter 2, section 2.2.2.

² The reasons why businesses use enterprise group structures is not the focus of this study. However, for a more detailed discussion on the issue see UNCITRAL Legislative Guide on Insolvency Law, Part Three; Treatment of Enterprise Groups in Insolvency, paragraphs 17-25.

³ *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, [hereinafter, *CCAA*]. To qualify for relief under the *CCAA* the debtor must be a Canadian incorporated company or a foreign incorporated company with assets in Canada or conducting business in Canada, be insolvent on a cash flow or balance sheet test and have in excess of \$5 million in debt. Therefore the *CCAA* is restricted to larger corporations. Debtors who do not reach the \$5 million threshold qualify for a Division 1 Proposal under the *Bankruptcy and Insolvency Act*, R.S. 1985, c. B-3, [hereinafter, *BIA*].

⁴ *Canada Business Corporation Act*, R.S., 1985, c. C-44, section 15(1).

of the remedy of substantive consolidation under the *CCAA* framework in both the domestic and cross-border context.

The remedy of substantive consolidation permits the court to treat the assets and liabilities of two or more enterprise group members as if they were part of a single insolvency estate. The practical effect is that creditor claims are satisfied from a common pool of assets, inter-company transactions are extinguished and a levelling of creditor recoveries occurs by decreasing the recoveries of some creditors and increasing the recoveries of others.⁵

The Canadian courts have played a direct role in developing the scope of substantive consolidation under the *CCAA* framework. Therefore, this thesis examines how substantive consolidation has evolved under the *CCAA* in order to investigate whether the current legal landscape provides the most appropriate framework for dealing with the key issues relating to substantive consolidation and consider how, if necessary, the position could be improved.

Accordingly, in Chapter 2 the methodology and scope of the research project is outlined. The scope of research objectives is identified and the reasons for employing a doctrinal analysis to achieve these objectives are explained. The key terms are defined and the variables that are excluded from the project are noted.

In Chapter 3, a rigorous doctrinal analysis of the existing jurisprudence is undertaken in order to gain a deeper understanding of how substantive consolidation has evolved under the *CCAA* framework. The Chapter suggests the current framework does not provide the most appropriate

⁵ UNCITRAL Working Group V, Report on Working Group V (Insolvency Law) on the work of its thirty-first session, Document A/CN.9/618, 11-15 December 2006, Vienna, at paragraph 39.

framework for dealing with the key issues relating to substantive consolidation in both the domestic and cross-border context. These key issues are identified as follows: (a) the standard used to determine whether there is a significant intertwining of assets and liabilities; (b) whether the monitor could bring an application for substantive consolidation or whether the court could make an order on its own initiative; (c) if the remedy of substantive consolidation can be applied to a solvent group member; (d) is notice is a prerequisite to an application, particularly when an application for consolidation is brought at the same time as an *ex parte* application for an initial stay of proceedings order and (e) how the remedy of substantive consolidation can be applied in cross-border context.

Chapter 4 looks towards the discussions of the UNCITRAL Working Group V in order to discover a suitable standard for determining whether there has been an intermingling of assets and liabilities. The Chapter suggests the “without disproportionate expense or delay” approach is most suited to the CCAA framework. The Chapter also examines whether the CCAA framework would benefit from adopting the alternative circumstance of “debtors disregarding their separateness to such an extent that creditors viewed them as one entity” as adopted in the United States and considered by UNCITRAL Working Group V. The Chapter suggests the test used to determine whether the debtors have disregarded their separateness and the effect on contractual claims demands careful consideration.

Chapter 5 examines the UNCITRAL Working Group V discussions on the key issues stemming from an application for substantive consolidation in the domestic context to determine how the current position could be improved. The Chapter argues there are clear advantages and safeguards to the monitor being permitted to make an application for substantive consolidation under the CCAA framework. However, the Chapter suggests the court should not be able to

grant an order for substantive consolidation on its own initiative. The Chapter also argues notice of an application should be provided at all stages of the proceedings and it is apparent the *CCAA* framework would not apply to solvent enterprise group members. However, it is conceded the current flexible approach to the timing of an application is the most appropriate, enabling the remedy to be available in a wide number of restructuring scenarios.

Chapter 6 explores the use of substantive consolidation in the cross-border context. The Chapter notes the use of the remedy on the international stage remains problematic due to; (a) the failure of the *CCAA* to recognize the existence of enterprise groups and the principle of cooperation in the context of enterprise groups, (b) the nature of substantive consolidation and (c) the difficulties cross-border cases generate such as the differing approaches to insolvency and cross-border insolvencies. However, the Chapter suggests extending the principle of cooperation to enterprise groups and continuing the use of cross-border protocols will facilitate the application of substantive consolidation in cross-border cases.

Finally, Chapter 7 concludes these points respectively.

Chapter 2: Methodology

2.1 Introduction

Legal scholars who employ a doctrinal analysis of law, albeit familiar with this traditional territory, can fail to clearly articulate the scope of the methodology used to achieve given research objectives. In the opinion of the author, it is an essential prerequisite of any research project. It provides a useful opportunity to determine the scope of the project with respect to its research objectives, sources and limitations. Therefore, this chapter carefully discusses the methodology used in this project.

This chapter has four parts. In the first section, the key terms used in this thesis are defined. In the second section, the research questions and variables that are excluded from the study are identified. In the third section the three research objectives are identified and the reasons for employing a doctrinal analysis to achieve these research objectives are explained. In the final section, the limitations of the research project are outlined.

2.2 Key Terms

2.2.1 Substantive Consolidation

Substantive consolidation is not defined by the statutory provisions of the *CCAA* or by the case law. Therefore, it is important at the outset to identify what an order for substantive consolidation entails and how it differs from other forms of consolidation and remedies.

Substantive consolidation is “the treatment of the assets and liabilities of two or more enterprise group members as if they were part of a single insolvency estate.”⁶ The practical effect of an

⁶ UNCITRAL Legislative Guide on Insolvency Law, Part Three; Treatment of Enterprise Groups in Insolvency, *supra*, footnote 1, at page 4.

order for substantive consolidation is that creditor claims are satisfied from a common pool of assets, inter-company transactions are extinguished and a levelling of creditor recoveries occurs by decreasing the recoveries of some creditors and increasing the recoveries of others.⁷

Substantive consolidation is an equitable remedy. Equitable remedies are distinguished from legal remedies. Legal remedies are available to a successful claimant as of right. Equitable remedies are always directed by the discretion of the court. Therefore, the Canadian courts continue to play a key role in the development and application of the remedy of substantive consolidation under the CCAA framework.

Substantive consolidation is distinct from an order that grants procedural consolidation.

Procedural consolidation⁸ defines the situation whereby the court administers insolvency proceedings of multiple entities as one proceeding. Hence, the insolvency estates remain separate and distinct. The assets and liabilities are not treated as if they were part of a single insolvency estate.

In addition, the remedy of substantive consolidation should not be confused with the notion of lifting the corporate veil. In some instances, the law is prepared to disregard or look behind the corporate form and have regard to the realities of the situation.⁹ Therefore, lifting the corporate veil, also known as piercing the corporate veil, involves treating the rights, liabilities or activities

⁷ UNCITRAL Working Group V, Report on Working Group V (Insolvency Law) on the work of its thirty-first session, Document A/CN.9/618, 11-15, December 2006, Vienna, at paragraph 39.

⁸ The term “procedural consolidation” is also referred to as “procedural coordination” in the UNCITRAL Legislative Guide on Insolvency Law, Part Three; Treatment of Enterprise Groups in Insolvency, *supra*, footnote 1 at page 4, as “the coordination of the administration of two or more insolvency proceedings in respect of enterprise group members. Each of those members, including its assets and liabilities, remains separate and distinct.”

⁹ Sealy L., and Worthington, S., *Cases and Materials in Company Law*, 8th ed. (Oxford: Oxford University Press, 2007), at pages 51-70.

of the corporation as the rights, activities or liabilities of its shareholders.¹⁰ The two doctrines appear similar since both ignore the orthodox principle of separate legal personality. However, there is a clear difference between them. Lifting of the corporate veil is a creditor's remedy against shareholders, disregarding the principle of limited liability. The doctrine of substantive consolidation, in principle, is a creditor's remedy against another creditor. There is a single insolvency estate where all assets and liabilities are pooled for all creditor claims.

However, this definition of substantive consolidation also incorporates the term enterprise group. Therefore, this term needs to be firmly analyzed against the existing legal framework of the CCAA and defined for the purpose of this study.

2.2.2. Enterprise Group

UNCITRAL Working Group V defines the term enterprise group as “two or more enterprises that are interconnected by control or significant ownership.”¹¹ The term enterprise refers to “any entity, regardless of its legal form, that is engaged in economic activities and may be governed by insolvency law.”¹² The term control refers to “the capacity to determine, directly or indirectly, the operating and financial policies of an enterprise.”¹³

The terms enterprise group and enterprise are not employed in the CCAA statutory provisions or in the existing jurisprudence. Rather, the statutory provisions provide the CCAA applies in respect of a debtor company or affiliated debtor companies if the total claims against the debtor

¹⁰ *Ibid*, at page 51.

¹¹ UNCITRAL Legislative Guide on Insolvency Law, Part Three; Treatment of Enterprise Groups in Insolvency, *supra*, footnote 1, at page 4.

¹² *Ibid*, at page 12.

¹³ *Ibid*.

company or affiliated debtor companies is greater than \$5 million.¹⁴ Section 2 *CCAA* defines the term company as “any company, corporation or legal person incorporated by, or under, an Act of Parliament or of the legislature of a province, any incorporated company having assets or doing business in Canada, wherever incorporated, and any income trust, but does not include banks, authorized foreign banks within the meaning of section 2 of the *Bank Act*¹⁵ railway or telegraph companies, insurance companies and companies to which the *Trust and Loan Companies Act*¹⁶ applies.” The *CCAA* defines affiliated companies as “companies are affiliated companies if (a) one of them is the subsidiary of the other or both are subsidiaries of the same company or each of them is controlled by the same person; and (b) two companies affiliated with the same company at the same time are deemed to be affiliated with each other.”¹⁷

Therefore, the terms enterprise group and enterprise appear wider than the terms employed in the *CCAA* framework. It includes types of legal entities that have been expressly excluded from the *CCAA*, such as banks and railway companies. Nevertheless, this Chapter argues the term enterprise group is a suitable working definition to describe what is commonly referred to as a corporate group. Although the limited application of the term enterprise group under the *CCAA* framework will be closely borne in mind.

¹⁴ *CCAA*, section 3(1).

¹⁵ *Bank Act*, 1991, c.46.

¹⁶ *Trust and Loan Companies Act*, 1991, c.7.

¹⁷ *CCAA*, section 3(2). “Company controlled” is also defined as, (3) for the purposes of this Act, a company is controlled by a person or by two or more companies if (a) securities of the company to which are attached more than fifty per cent of the votes that may be cast to elect directors of the company are held, other than by way of security only, by or for the benefit of that person or by or for the benefit of those companies; and (b) the votes attached to those securities are sufficient, if exercised, to elect a majority of the directors of the company.

2.2.3 Domestic and Cross-Border

This thesis focuses on the remedy of substantive consolidation under the *CCAA* in both domestic and cross-border restructuring scenarios. The domestic context signifies the debtors, assets and liabilities are *all* within the jurisdictional reach of the Canadian courts and legislation. The cross-border context defines circumstances whereby the debtor has creditors, assets or liabilities in two or more jurisdictions.

2.3 Questions and Variables Excluded From the Study

2.3.1 Only the *CCAA*

In Canada, there are three principal statutes that provide mechanisms to tackle the insolvency of personal or corporate debtors; the *CCAA*, the *BIA* and the *Winding-up and Restructuring Act*.¹⁸ However, this research project solely focuses on the doctrine of substantive consolidation in the context of the *CCAA*.¹⁹

The key reason for excluding the *BIA* and the *WURA* from this research project is that each statute has differing policy objectives and considerations that must be taken into account. The *CCAA* allows a debtor with debts over \$5 million to negotiate a formal plan of arrangement or compromise with its creditors. Therefore, the primary aim of the *CCAA* is to restructure the affairs of large financially troubled corporate debtors.²⁰

¹⁸ *Winding-up and Restructuring Act*, R.S., 1985, c. W-11., [hereinafter *WURA*].

¹⁹ It should be noted that the *BIA* does, in part, become part of the discussion in this project since the statute provides the hierarchy for the satisfaction of claims for actions brought under the debtor under the *CCAA*. However, the *BIA* is only referred to for this purpose only. The development the remedy of substantive consolidation under the *BIA* requires further future research.

²⁰ It should be noted that *CCAA* does provide for liquidation in some cases.

The *CCAA* can be contrasted to the policy objectives of the two other statutes. The *BIA* provides a legislative framework for the liquidation of the assets of an insolvent individual, corporation or partnership and the distribution of the proceeds in a fair and orderly way among the creditors. It provides for the appointment of a trustee to take charge of the assets, sell them and distribute the proceeds. Alternatively, the Act provides ways for insolvent businesses or consumer debtors to avoid bankruptcy by negotiating arrangements with their creditors for the compromise of their debts and the reorganization of their financial affairs.²¹ The *WURA* addresses financially distressed financial institutions and certain companies,²² allowing such companies to be liquidated or restructured.

Therefore, the assessment of substantive consolidation in the context of *CCAA* facilitates a focussed discussion. It avoids the complex task of juggling varying policy objectives and considerations that may conflict or vary widely.

2.3.2 Confining the Study to Law

This project focuses on the legal dimensions of the doctrine of substantive consolidation under the *CCAA*. That is to say, this project concentrates on the law rather than possible business, economic or social dimensions. Although conclusions drawn about the law may have business, economic and social impacts, this is beyond the scope of the project and requires future research.

²¹ Industry Canada, Corporate and Insolvency Law Policy, see: http://www.ic.gc.ca/eic/site/cilp-pdci.nsf/eng/h_cl00021.html.

²² *WURA*, section 6(1) notes this includes banks and savings banks, to authorized foreign banks, and to trust companies, insurance companies, loan companies having borrowing powers, building societies having a capital stock.

2.3.3 Confining the Discussion to Substantive Consolidation

This project exclusively examines the remedy of substantive consolidation in the context of the CCAA despite the availability of various remedies that could be employed in the restructuring of insolvent enterprise group such as procedural coordination,²³ the extension of liability,²⁴ contribution orders.²⁵ The aim of this project is to carefully examine the remedy of substantive consolidation and achieve the research objectives given the resources, time constraints and funding available.

2.4 Research Objectives and Methods

2.4.1 The Research Objectives

The term research objective is defined by Hussey and Hussey as “a statement of the exact things a research exercise intends to find out.”²⁶ The formulation of research objectives can help focus the research project and avoid collecting data that is not strictly necessary for understanding or solving the problems identified. The three research objectives of this project are; (a) to gain a deeper understanding of how substantive consolidation has evolved under the CCAA, (b) to investigate whether the current legal landscape provides the most appropriate framework for dealing with the key issues relating to substantive consolidation in both the domestic and cross-

²³ UNCITRAL Legislative Guide on Insolvency Law, Part Three; Treatment of Enterprise Groups in Insolvency, *supra*, footnote 1, at page 4.

²⁴ *Ibid.*, at page 45. The “extension of liability” is whereby shareholders, who are generally shielded from liability from the enterprise’s activities, being held liable for certain activities.

²⁵ *Ibid.*, at page 48. A “contribution order” is an order by which the court can require a solvent group member to contribute specific funds of the debts other group members subject to insolvency proceedings, particularly where the solvent group member has acted inappropriately towards the insolvent group member. Such inappropriate behaviour may include, for example, transferring the assets of a failing group member to another group member for an inadequate price or one group member taking the benefit of tax advantages accruing to a failing group member and leaving the creditors of the failing member to a reduced payout in a subsequent insolvency.

²⁶ Hussey, J., and Hussey, R., *Business Research: a Practical Guide for Undergraduate and Postgraduate Students*, (London: MacMillan, 1997), at pages 116-123.

border context, and (c) consider how, if necessary, the position could be improved. Since substantive consolidation has evolved as a judicially-created remedy, the six reported cases that discuss issues pertinent to the doctrine will be examined. Hence, a traditional doctrinal analysis will be employed.

2.4.2 The Meaning of Doctrinal Analysis

Doctrinal analysis is described somewhat differently by commentators. Tiller and Cross suggest doctrinal analysis is a research method whereby a researcher examines the content of a legal opinion to evaluate whether it was effectively reasoned or to explore its implications for future cases, grounded in a descriptive premise that reasoned argument from doctrinal premises actually explained judicial decisions.²⁷ However, Posner argues doctrinal analysis has a narrower scope; the careful reading and comparison of appellate opinions with a view to identifying ambiguities, exposing inconsistencies and developing distinctions.²⁸

Tiller and Cross's description is more suited to analyzing the six reported cases since the description lacks the demand for any precedential weight. However, the analytical process described by Posner, analysing the six judgements with a view to identifying ambiguities, exposing inconsistencies and developing distinctions will be exercised in order to achieve the research objectives.

²⁷ Tiller, E., and Cross, F., "What is Legal Doctrine," (2006) 100 *North-Western University Law Review*, 517.

²⁸ Posner, R., "The Present Situation of Legal Scholarship," (1980) 90 *Yale Law Journal*, 1113 at page 1113.

2.4.3 Doctrinal Analysis of the Jurisprudence

The existing scholarly literature that has examined the doctrine of substantive consolidation in the context of the CCAA indicates previous researchers have adopted a doctrinal analysis.

Rotsztain and De Cicco²⁹ examined five of the six reported cases³⁰ by rigorously comparing, contrasting and evaluating the judicial reasoning in each. By doing so, they concluded the judgements fail to offer any guidance as to how courts should attack the consolidation inquiry.

Similarly, Sarra explored the same research question with the same method, identifying a lacuna in the judicial reasoning as to the principles to be applied when determining whether to grant an order for substantive consolidation.³¹

These previous studies indicate a doctrinal analysis is a suitable research method for achieving the first research objective. Since the remedy of substantive consolidation has evolved as a judicially-created doctrine, it is fundamental to examine the development of the jurisprudence in order to situate it within the current legal framework of the CCAA.

2.4.4 Doctrinal Analysis of UNCITRAL Working Group V Documents

The second research objective of this project is to investigate whether the current legal landscape provides the most appropriate framework for dealing with the key issues relating to substantive consolidation in both the domestic and cross-border context. The third research objective is to consider how, if necessary, the position could be improved. In order to achieve these research

²⁹ Rotsztain, M. B., and De Cicco, N., “Substantive Consolidation in CCAA Restructurings: A Critical Analysis,” in Sarra, J. P., ed., *2004, Annual Review of Insolvency Law*, (Toronto: ThomsonCarswell, 2004), [hereinafter Rotsztain and De Cicco].

³⁰ The case of *Atlantic Yarns Inc., Re*, 2008 CarswellNB 195, 2008 NBQB 144, 42 C.B.R. (5th) 107, 855 A.P.R. 143, 333 N.B.R. (2d) 143, (N.B.Q.B.) was not available at the time of Rotsztain and De Cicco’s publication.

³¹ Sarra, J. P., “Corporate Group Insolvencies: Seeing the Forest and the Trees,” (2008) 24(1) *Banking and Finance Law Review*, 63.

objectives, the UNCITRAL Working Group V literature is examined in order to suggest various policy options for the approach under the CCAA.

In 2006, UNCITRAL Working Group V began examining various policy issues relating to the insolvency of an enterprise group. Since then, UNCITRAL Working Group V have held eight sessions, generating over 700 pages of documents in the form of Reports by Working Group V and various Working Papers by the Secretariat.³² The Reports reflect the discussions, deliberations and decisions at the half-yearly sessions whereby the Working Papers by the Secretariat are used to produce draft legislative recommendations and commentary.

Given the large volume of text to be examined, a chronological annotated bibliography will be employed to detail the grand narrative arch that has developed since the UNCITRAL Working Group V sessions began in 2006. Using a chronological annotated bibliography appears the most appropriate method of organising the findings in the documents given the size of the sources used and the time constraints on this project. However, this research project will also allude to the micro aspects of the text where appropriate.

2.5 Limitations

It is important to bear in mind the limitations posed by the sources used to make claims about the law. This section highlights the constraints posed by the two sources used in this research project; the case law and UNCITRAL Working Group V documents.

³² For full list and access to Reports of Working Group V (Insolvency Law) and Notes by the Secretariat see: http://www.UNCITRAL.org/UNCITRAL/en/commission/working_groups/5Insolvency.html.

2.5.1 Case Law

This project examines, and relies upon, court judgements to make assertions about the current legal framework of substantive consolidation under the *CCAA*. However, a court judgement fails to capture the verbal submissions made in the court room and the written texts submitted to the court, such as affidavits. The practical effect is that court judgements do not reflect all the voices and texts that have been considered or heard in the case. It is impossible, unless stated in the text of the judgement, to truly understand the position of all the parties. Yet, even where the judgement articulates these points it may fail to take into account the subjective view of the parties. Therefore, the transcripts of a hearing or trial can be seen as a more favourable source to achieving this purpose. However, since this project is constrained by its time limits, a qualitative study assessing the transcripts is not feasible and therefore must be examined in future research. Nevertheless, it is argued the inherent limitation posed by a court judgement does not diminish the ability to assert the legal outcome of the case. The judgement signifies the legal verdict; the decision arrived at and pronounced by the court of law.

2.5.2 UNCITRAL Working Group V Documents

UNCITRAL Working Group V is composed of all state members of the UNCITRAL Commission. The half yearly sessions are attended by representatives from these states and observers from various international organisations, such as the International Monetary Fund and the World Bank. The Reports are a reflection of the dialogue at these sessions. However, although the Reports attempt to convey the spoken conversation between the many representatives, the text carries an inherent limitation.

The Reports echo the conversation between the representatives present at the sessions. The text summarizes an array of topics discussed by the Group, identifies the various concerns or suggestions by the Group and outlines decisions reached by the Group. However, the written text does not fully convey the oral discussions between the representatives present at the sessions. The practical effect for the purpose of this project is two-fold. Firstly, any concerns, proposals or suggestions made by the Canadian representatives are disguised and suppressed in the text. Secondly, the written text fails to capture the length or depth of discussion on a particular issue. Nonetheless, it is argued the documents still function as a useful source to draw conclusions about the various issues relating to the doctrine of substantive consolidation.

2.6 Conclusion

In this Chapter, the methodological approach used to achieve the three research objectives was examined. Firstly, the key terms were defined. Secondly, the variables and questions that are excluded from the study were identified. By restricting the study to the law, the remedy of substantive consolidation and the *CCAA* framework, the parameters of the research project have been recognised.

In the third section the meaning of doctrinal analysis was explored and examples of this approach were provided. It is argued by using a doctrinal analysis to examine the existing jurisprudence and UNCITRAL Working Group V documents it becomes possible to make assertions about the current legal framework and determine whether how, if necessary, the position could be improved.

Finally, the inherent limitations of the sources used have been recognised. Both the court judgements and the UNCITRAL Working Group V documents fail to capture the spoken

dialogue at the hearings or sessions, being disguised and suppressed in the text. However, despite recognising these inherent limitations, it is argued it does not hinder the ability to draw conclusions about the law.

In the following Chapter, a doctrinal analysis of the existing jurisprudence is employed in order to gain a deeper understanding of how substantive consolidation has evolved under the *CCAA*.

Chapter 3: The Doctrine of Substantive Consolidation in the Context of the CCAA

3.1 Introduction

The doctrine of substantive consolidation under the CCAA still appears to be in relative infancy.³³ In the absence of codified provisions, substantive consolidation has leisurely evolved as a judicially-created remedy, courts relying upon their broad statutory authority to grant such orders.³⁴ In the last twenty years, there have only been six reported cases³⁵ that specifically analyze issues surrounding the doctrine in the domestic context.³⁶ Yet, the judicial dialogue that emerges from the six reported cases appears to reflect the pressing view of the UNCITRAL Working Group V. That is to say, the discussion concentrates on the circumstances in which it might be appropriate to consolidate insolvency estates in the domestic setting.³⁷ Similarly, the small but valuable amount of scholarly literature on the existing jurisprudence has only focussed on examining these circumstances.³⁸

³³ Rotsztain and De Cicco, *supra*, footnote 29.

³⁴ For a detailed discussion on the courts authority and interpretative tools see Jackson R., and Sarra, J. P., “Selecting the Judicial Tool to get the Job Done: An Examination of Statutory Interpretation, Discretionary Power and Inherent Jurisdiction in Insolvency Matters,” in Sarra, J. P., ed., 2007, *Annual Review of Insolvency Law*, (Vancouver: ThomsonCarswell, 2007). The authors suggest the courts should adopt a hierarchal approach to the interpretative tools; statutory interpretation, gap-filling, discretion and inherent jurisdiction. However, the case of *ATB Financial v. Metcalfe & Mansfield Alternative Investment II Corp.*, 2008 ONCA 587 (Ont. C.A.) suggests it is not necessary to go beyond the general principle of statutory interpretation when the implicit language of the CCAA itself gives the court such authority, hence there is no gap filling to be done and no need to fall back on inherent jurisdiction, see R. A. Blair J. J. A. at paragraphs 43-49.

³⁵ The six reported cases consist of both common law and civil law Canadian cases.

³⁶ Rotsztain and De Cicco, *supra*, footnote 29, at page 343 note despite the scarcity of case law that relates to the doctrine of substantive consolidation under the CCAA, numerous consolidated plans of arrangement have been sanctioned by the courts. However, the author of this thesis notes there has yet to be a Canadian case that discusses substantive consolidation in the international context.

³⁷ UNCITRAL Working Group V, Note by Secretariat, Document A/CN.9/WG.V/WP.90, 9-13 November 2009, Vienna, at paragraph 45.

³⁸ Rotsztain and De Cicco, *supra*, footnote 29; Sarra, J. P., *Rescue! The Companies' Creditors Arrangement Act*, (Toronto: ThomsonCarswell, 2007), at page 242; Sarra, *Seeing the Forest and the Trees*, *supra*, footnote 31; MacNaughton, M., and Arzoumanidis, M., “Substantive Consolidation in the

Therefore, the aim of this Chapter is to go beyond the assessment already undertaken by other scholars; to gain a deeper understanding of how substantive consolidation has evolved under the CCAA in order to investigate whether the current legal landscape provides the most appropriate framework for dealing with the key issues relating to substantive consolidation. The key issues that are the focus of this Chapter are: (a) the factors supporting substantive consolidation, (b) the effect of substantive consolidation and (c) the various issues relating to the application for an order, such as the persons permitted to apply, timing of an application, inclusion of a solvent group member and notice.

This chapter has three parts. The first section examines the jurisprudence to determine the factors that support an order for substantive consolidation. The second section explores the judicial dialogue on the effects of consolidation. Finally, the third section investigates the issues relating to an application for consolidation: the parties able to make application, timing of application, the issue of notice and the inclusion of a solvent debtor company.

Insolvency of Corporate Group: A Comparative Analysis,” in Sarra, J. P., ed., 2007, *Annual Review of Insolvency Law*, (Toronto: ThomsonCarswell, 2007); Posno, B., “Substantive Consolidation in Canada,” for full text see: www.blakes.com/english/publications/RI/pdf/Paper102.pdf; MacNaughton, M., “Classification, Consolidation and Context: A Canadian Approach to Substantive Consolidation,” (2009) 25 *Banking and Finance Law Review*, 141; Hayes, E., “Substantive Consolidation under the Companies’ Creditors Arrangement Act and the Bankruptcy and Insolvency Act,” (1994) 23 *Canadian Business Law Journal*, 444.

3.2 The Factors Supporting Consolidation

3.2.1 Introduction

It has been suggested by several commentators that the Canadian courts have failed to articulate a clear set of factors that should be considered when determining the circumstances in which consolidation should occur in the context of the *CCAA*.³⁹ However, the recent direction given by the New Brunswick Queen's Bench in the case of *Atlantic Yarns* suggests there is a broad set of principles to be applied. Hence, this section examines the case of *Atlantic Yarns*. Yet, in order to better understand the current approach laid down in *Atlantic Yarns*, this section first reflects on the evolution of the doctrine by undertaking a chronological review of the pre-existing case law.

3.2.2 Northland Properties

Prior to the case of *Atlantic Yarns*, the decision of the British Columbia Supreme Court in *Northland Properties*⁴⁰ was considered the leading case on the appropriate circumstances a court should grant an order for substantive consolidation in the context of the *CCAA*. It is also the first Canadian case to engage with the issue of substantive consolidation.

In the case, the debtor companies sought an order merging and consolidating for all purposes. Due to the scarcity of Canadian cases dealing with the subject, Justice Trainor turned to United States jurisprudence that, at the time, adopted a variety of approaches to the factors supporting

³⁹ *Ibid.*

⁴⁰ *Northland Properties Ltd., Re*, 1988 CarswellBC 531, 69 C.B.R. (N.S.) 266, 29 B.C.L.R. (2d) 257, 73 C.B.R. (N.S.) 146, [1988] B.C.W.L.D. 2663, [1988] C.L.D. 1460, 11 A.C.W.S. (3d) 76, (B.C.S.C), [hereinafter *Northland Properties*].

consolidation. First, Justice Trainor referred to the case of *Baker and Getty Financial Services Inc., Re.*⁴¹

In the *Baker* case the Ohio Bankruptcy Court noted the propriety of ordering substantive consolidation is determined by a balancing of interest. The relevant enquiry asks whether the creditors will suffer greater prejudice in the absence of consolidation than the debtors (and any objecting creditor) will suffer from its imposition.⁴²

Secondly, Justice Trainor considered the seven “elements of consolidation” identified in the case of *Vecco Const. Indust. Inc., Re;*⁴³

“(1) the difficulty in segregating assets, (2) the presence of consolidated financial statements, (3) the profitability of consolidating at a single location, (4) the commingling of assets and business functions, (5) unity of interest in ownership, (6) the existence of intercorporate loan guarantees, and (7) the transfer of assets without observance of corporate formalities.”⁴⁴

Finally, Justice Trainor accepted the view of the court in *Snider Brothers Inc., Re,*⁴⁵ where the court held:

“A review of the case law reveals equity has provided the remedy of consolidation where it has been shown that the possibility of economic prejudice which could result from continued corporate separateness outweighed the minimal prejudice that consolidation

⁴¹ *Baker and Getty Financial Services Inc., Re*, 78 B.R. 139 (U.S.B.R. D. Ohio, 1987), [hereinafter *Baker*].

⁴² *Northland Properties*, *supra*, footnote 40 *per* Justice Trainor at paragraph 49.

⁴³ *Vecco Construction. Industries Inc., Re*, 3 B.R. (Bankr. E.D. Va, 1980), [hereinafter *Vecco*].

⁴⁴ *Ibid.*, page 410.

⁴⁵ *Snider Brothers Inc., Re*, 18. B.R. 230 (U.S. Bankr. Mass., 1982), [hereinafter *Snider*].

would cause. While several courts have tried to delineate what might be called the “elements of consolidation” ...the only real criterion is the economic prejudice of continued debtor separateness versus the economic prejudice of consolidation.”⁴⁶

“The evidence in support of an application to consolidate must do more than show a unity of interest or intermingling of funds. It must be show a harm which has resulted there from or that prejudice will result from a lack of consolidation...hence it must be clearly shown that not only are the “elements of consolidation” present in a given bankruptcy setting, but that the courts action is both necessary to prevent harm or prejudice, or to effect a benefit generally.”⁴⁷

Justice Trainor accepted the analysis in the *Snider* case stating it would be improper for the court to interfere or appear to interfere with the rights of the creditors.⁴⁸ On the facts of the case the order sought was refused. However, the approach taken by Justice Trainor was confirmed by the British Columbia Court of Appeal as the correct test for substantive consolidation.⁴⁹

Some commentators have attempted to formulate tests from the analysis given by Justice Trainor. Hayes describes Justice Trainor’s approach as a two-step test.⁵⁰ First, it must be shown there is a need for consolidation. Second, the equities favouring consolidation must outweigh the

⁴⁶ *Ibid.*, page 234.

⁴⁷ *Ibid.*, page 238.

⁴⁸ *Northland Properties, supra*, footnote 40 *per* Justice Trainor at 59.

⁴⁹ *Northland Properties Ltd., Re*, (1989), (sub nom. *Northland Properties Ltd. v. Excelsior Life Insurance Co. of Canada*) 73 C.B.R. (N.S.) 195 (B.C.C.A.).

⁵⁰ Hayes, *supra*, footnote 38 at page 448.

equities favouring continued debtor separateness. However, Knowles and Zimmerman⁵¹ argue although the court comingled the two approaches, ultimately the focus of the reasoning was on the “economic prejudice test” laid down in *Snider*. Nevertheless, commentators appeared to be satisfied the case of *Northland Properties* provided the best available guidance on the doctrine.⁵²

However, the subsequent four cases of *Fairview Industries*, *Lehndorff*, *Global Light* and *PSINet* proceeded to be heavily criticised by several commentators for two key reasons. First, the cases fail to review or even take into account the approach taken by Justice Trainor in *Northland Properties*. Secondly, as Rotsztain and De Cicco suggest, the cases fail to result in the development of significant additional jurisprudence.⁵³ A review of the judicial reasoning echoes these concerns.

3.2.3 Fairview Industries

In the case of *Fairview Industries*⁵⁴ an application for substantive consolidation of six debtor companies was brought before the Nova Scotia Supreme Court. The court noted substantive consolidation is available in appropriate circumstances. In the case, since there was an interlocking of finances a consolidation order was appropriate.⁵⁵ However, since the evidence required to achieve approval from creditors was not before the court, Chief Justice Glube held the order shall be amended to state that two companies that were not considered hopelessly

⁵¹ Knowles, D., and Zimmerman, A., “Further Developments and Trends in the *Companies’ Creditors Arrangement Act: 1992*,” *Insolvency Institute of Canada*, October 1992 at paragraph 112, online at Westlaw, InsolvencySource. This was also the view of Rotsztain and De Cicco, *supra*, footnote 30.

⁵² Rotsztain and De Cicco, *supra*, footnote 29, at page 343.

⁵³ *Ibid*, page 340.

⁵⁴ *Fairview Industries Ltd., Re*, 1991 CarswellNS 35, 11 C.B.R. (3d) 43, (sub nom. Fairview Industries Ltd., Re (No.2)), 109 N.S.R. (2d) 12, 297 (N.S.S.C. (Trial Division)), [hereinafter *Fairview Industries*].

⁵⁵ *Ibid.*, per Chief Justice Glube at paragraph 76.

insolvent shall file a separate plan of compromise and arrangement.⁵⁶ The consolidation plan of the other four companies was left to the companies to decide whether it was practical.⁵⁷

3.2.4 Lehndorff

In the case of *Lehndorff*,⁵⁸ an application under the CCAA to file a consolidated plan of compromise was brought before the Ontario Court of Justice. The court held it was appropriate that a consolidated plan be approved. Nonetheless, the court did not identify any judicial authority or cite the test that should be applied. In rendering his decision, Justice Farley looked towards significantly intertwined business operations that included multiple instances of inter-corporate debt, cross-default provisions, guarantees and a centralized cash management system.⁵⁹

3.2.5 Global Light

In the case of *Global Light*,⁶⁰ an application by the debtor companies for an order under the CCAA approving a consolidated plan of compromise was brought before the British Columbia Supreme Court. Despite an objection from a creditor, the court granted the order. In considering whether to sanction the plan of compromise and arrangement, the court took into account four factors. Firstly, the objecting creditor had not previously opposed the plan despite having the opportunity to do so. Secondly, all creditors dealt with the parent company. Thirdly, the plan had

⁵⁶ *Ibid.*, per Chief Justice Glube at paragraph 81.

⁵⁷ *Ibid.*, per Chief Justice Glube at paragraph 81.

⁵⁸ *Lehndorff General Partner Ltd., Re*, 1993 CarswellOnt 183, 17 C.B.R. (3d) 24, 9 B.L.R. (2d) 274 (O.C.J. [General Division – Commercial List]), [hereinafter *Lehndorff*].

⁵⁹ *Ibid.*, per Justice Farley at paragraph 2.

⁶⁰ *Global Light Telecommunications Inc., Re*, 2004 CarswellBC 1249, 2004 BCSC. 745, 2 C.B.R. (5th) 210, 33 B.C.L.R. (4th) 155, (B.C.S.C.), [hereinafter *Global Light*].

been approved by a significant majority of creditors. Fourthly, the plan was fair and reasonable.⁶¹

In addressing the question of fairness and reasonableness, Justice Pitfield noted that the court must not insist on perfection with respect to fairness and reasonableness. Rather a fair and reasonable plan is meant to be an equitable arrangement in the nature of a compromise.⁶²

3.2.6 PSINet

In the case of *PSINet*,⁶³ the debtor companies brought a motion before the Ontario Superior Court to sanction a consolidated plan of compromise or arrangement. The court granted the order noting that the consolidation plan avoided the complex and likely litigious issues surrounding the allocation of the proceedings from the sale of assets, reflected the intertwined nature of the business and in the circumstances was fair and reasonable.⁶⁴ Yet, the court did not review the existing jurisprudence, such as Justice Trainor's approach in *Northland Properties*. Rather, Justice Farley simply noted that while consolidation by its very nature will benefit some creditors and prejudice others, it is appropriate to look at the overall general effect.⁶⁵

3.2.7 The Lacuna in the Judicial Reasoning

MacNaughton and Arzoumanidis argue the four cases do not address the issue of substantive consolidation in any meaningful way and do not offer any guidance as to how courts should attack the consolidation inquiry.⁶⁶ Indeed it does appear the courts take a fact-specific approach,

⁶¹ The court referred to the three stage test for sanctioning a plan of compromise and arrangement laid down in the British Columbia Court of Appeal decision in *Northland Properties Ltd., Re*, (1989) 73 C.B.R. (N.S.) 195 (B.C.C.A.), *supra*, footnote 49.

⁶² *Sammi Atlas Inc., Re*, (1988), 3 C.B.R. (4th) 171 (O.C.J. (General Division Commercial List)).

⁶³ *PSINet Ltd., Re*, 2002 CarswellOnt 1261, 33 C.B.R. (4th) 284, 113 A.C.W. (3d) 760, (O.S.C.J. [Commercial List]), [hereinafter *PSINet*].

⁶⁴ *Ibid.*, per Justice Farley at paragraph 2.

⁶⁵ *Ibid.*, per Justice Farley at paragraph 11.

⁶⁶ MacNaughton and Arzoumanidis, *supra*, footnote 38.

looking towards what Knowles and Zimmerman have referred to as “debtor-attributes,” such as significant intermingling of business operations and finances.⁶⁷ Consequently, the line of jurisprudence appeared to create what Sarra described as a “lacuna” in the judicial reasoning as to the principles to be applied.⁶⁸

As a result of the case-by-case line of jurisprudence that developed, the case of *Northland Properties* was considered the leading authority on the factors supporting substantive consolidation. However, the more recent case of *Atlantic Yarns* suggests there is a broad set of principles that should be used to determine the factors that support consolidation under the CCAA framework.

3.2.8 Atlantic Yarns

In the case of *Atlantic Yarns*, the debtor companies filed a consolidated plan of compromise and arrangement with the court under the CCAA. The plan encompassed two classes of creditors for the purposes of voting on the proposed plan; a secured class and an unsecured class. A motion was brought by a secured creditor asserting there should be no consolidation of creditors for voting purposes as set out in the proposed plan. The issue before the New Brunswick Court of Queen’s Bench was whether there should be a consolidated plan of compromise or arrangement in the circumstances.

In determining whether substantive consolidation should be granted, Justice Glennie first referred to the analysis given by Sarra in *Rescue! The Companies' Creditors Arrangement Act*.⁶⁹

⁶⁷ Knowles and Zimmerman, *supra*, footnote 51.

⁶⁸ Sarra, *Rescue*, *supra*, footnote 38.

⁶⁹ Sarra, *Seeing the Forest and the Trees*, *supra*, footnote 31.

The court will allow a consolidated plan of compromise and arrangement to be filed for two or more related companies in appropriate circumstances...Generally, the courts will determine whether to consolidate proceedings by assessing whether the benefits will outweigh the prejudice to particular creditors if the proceedings are consolidated. In particular, the court will examine whether the assets and liabilities are so intertwined that it is difficult to separate them for purposes of dealing with different entities. The court will also consider whether consolidation is fair and reasonable in the circumstances of the case.

Guided by this analysis, Justice Glennie proceeded to review the “two-step” test taken by the court in the case of *Northland Properties*. Firstly, there must be a balancing of interests, ensuring the creditors will suffer greater prejudice in the absence of consolidation than the debtors will suffer from its imposition. Secondly, the elements of consolidation must be present. Finally, Justice Glennie referred to the case of *PSINet* whereby Justice Farley noted whilst consolidation by its very nature will benefit some creditors and prejudice others, it is appropriate to look at the overall general effect.⁷⁰

Therefore, the approach taken by Justice Glennie can be formulated into three principles. Firstly, consolidation must be appropriate in the circumstances. The court must determine whether the elements of consolidation are present, such as the significant intertwining of assets and liabilities. Secondly, there must be a balancing of interests, ensuring the benefits will outweigh the prejudice to particular creditors if the debtor estates are consolidated. Thirdly, it is appropriate to

⁷⁰ *PSINet*, *supra*, footnote 63 *per* Justice Farley at paragraph 11.

look at the overall effect of consolidation. The court will consider whether consolidation is fair and reasonable in the circumstances of the case.⁷¹

3.2.8.1 Significance of Atlantic Yarns

The case of *Atlantic Yarns* is the most significant decision on the factors supporting substantive consolidation since the case of *Northland Properties*. For many years commentators have suggested the jurisprudence only boasts inconsistent and fact specific judgements, failing to result in any meaningful guidance.⁷²

However, the case of *Atlantic Yarns* has confirmed that the questions to be asked in determining whether to grant consolidation are the same as they were twenty years ago at the time of Justice Trainor's judgement in *Northland Properties*, only supplemented with the need to ensure the overall effect of consolidation is fair and reasonable. The approach is both flexible and broad; ensuring the factors supporting consolidation can be applied in a variety of *CCAA* cases.

Yet, the case of *Atlantic Yarns* can be criticised for failing to provide detailed guidance on the circumstances supporting consolidation in two areas. Firstly, it is unclear what test should apply in order to determine whether there is an intertwining of assets and liabilities. For example, should the test be that it is impossible to disentangle assets and liabilities? Or, in the alternative, the unscrambling of assets and liabilities creates disproportionate additional expense or delay to the proceedings? Secondly, can substantive consolidation be applied in circumstances where the creditors extend credit based on the notion of the enterprise group?

⁷¹ Sarra, *Seeing the Forest and the Trees*, *supra*, footnote 31.

⁷² See Rotszain and De Cicco, *supra*, footnote 29; Sarra, *Seeing the Forest and the Trees*, *supra*, footnote 31; MacNaughton, *supra*, footnote 38.

3.3 The Effect of Consolidation

3.3.1 Introduction

The effects of consolidation are wide ranging and can vary depending on the facts of the case. Nevertheless, the aim of this section to identify the common consequences of consolidation outlined in the jurisprudence.

3.3.2 The Judicial Dialogue

The judicial dialogue has focussed on two common effects of consolidation. Firstly, the courts note consolidation has the potential to prejudice the rights of creditors stemming from the levelling of recoveries. In the case of *Northland Properties*, Justice Trainor referred to the analysis given in *Snider* that “substantive consolidation, in all most all instances, threatens to prejudice the rights of creditors...this is so because separate debtors will almost always have different ratios of assets to liabilities. Thus the creditors of a debtor whose asset-to-liability ratio is higher than that of its affiliated debtor must lose to the extent that the asset-to liability ratio of the merged estates will be lower.”⁷³ In *PSINet*, Justice Farley also noted that consolidation by its very nature will benefit some creditors and prejudice others.⁷⁴ The practical effect is best illustrated by the helpful example given by MacNaughton and Arzoumanidis. Assume Company A has \$6 million in liabilities and \$1 million in assets, assumer further Company B is a related company and had \$4 million in liabilities and \$2 million in assets. Outside consolidation, creditors of Company A would receive 17 cents on the dollar for their claims, while creditors of

⁷³ *Snider, supra*, footnote 45 at page 234.

⁷⁴ *PSINet, supra*, footnote 63 *per* Justice Farley at paragraph 11.

Company B would receive 50 cents on the dollar. In substantive consolidation, all creditors will receive 30 cents on the dollar for their claims.⁷⁵

Secondly, the courts have recognised the extinguishment of inter-company debts and obligations is an effect of consolidation. In *Global Light*, Justice Pitfield held the consolidated plan would deprive the creditor of the right to seek to recover on its guarantees.⁷⁶

However, there remain several topics that have failed to be discussed by the courts or the scholarly literature. These include: Should there be a combined meeting of creditors? Can certain assets or claims be excluded from the consolidation? These questions demand answers in order to promote certainty in the insolvency proceedings.

3.4 Application for Consolidation

3.4.1 Introduction

An application for substantive consolidation under the CCAA raises many questions. Which parties are able to make an application? At what time in the proceedings can an application be made to the court? Is notice to affected parties a prerequisite? Can a solvent debtor company be included in the consolidation? This section looks towards the jurisprudence to find answers to these four questions.

3.4.2 Parties Able to Make an Application for Substantive Consolidation

The existing jurisprudence highlights that in most cases the debtor makes an application for an order for substantive consolidation. In the cases of *Northland Properties* and *PSINet* a motion was brought by the debtor for an order that merged and consolidated their reorganisation for all

⁷⁵ MacNaughton and Arzoumanidis, *supra*, footnote 38 at page 529.

⁷⁶ *Global Light*, *supra*, footnote 60 per Justice Pitfield at paragraph 22.

purposes.⁷⁷ Similarly in the case of *Lehndorff*, the application for consolidation was brought by debtor companies for an order sanctioning a consolidated plan of compromise and arrangement that had been approved by creditors.⁷⁸ This finding is largely unsurprising. Sarra notes that in most CCAA cases the debtor company proposes a plan of arrangement and compromise.⁷⁹ The debtor company is well placed to discuss and negotiate with all creditors the terms of the substantive consolidation plan and propose it to the court.

The case of *Fairview Industries* also indicates the court will permit an application for substantive consolidation by creditors. In the case the issue of consolidation was raised by both the debtors and its creditors.⁸⁰ The case of *Atlantic Yarns* also suggests a creditor may bring a motion challenging the application for substantive consolidation. A motion was brought by a secured creditor challenging the voting procedures set out in relation to the proposed consolidated plan of compromise and arrangement filed by the debtor companies. Yet, the existing case law fails to indicate whether an application can be made by the monitor, or whether the court is permitted to order consolidation on its own initiative. These issues will be examined later in Chapter 5 of this thesis.

3.4.3 Timing of Application

The case law highlights that in most CCAA cases an application for substantive consolidation is made *after* the initial order, at a subsequent hearing when the debtor companies are requesting the court to sanction a consolidated plan of compromise and arrangement.⁸¹ However, in some cases it may be impossible to grant consolidation at a late stage in the proceedings when key

⁷⁷ *Northland Properties, supra*, footnote 40 per Justice Trainor at paragraph 27.

⁷⁸ *Global Light, supra*, footnote 60 per Justice Pitfield at paragraph 1.

⁷⁹ Sarra, *Seeing the Forest and the Trees, supra*, footnote 31, page 233.

⁸⁰ *Fairview Industries, supra*, footnote 54 per Chief Justice Glube at paragraph 38.

⁸¹ See *Northland Properties, Fairview, PSINet, Global Light* and *Atlantic Yarns*.

matters may have been resolved, such as the sale or disposal of assets. Therefore, the case of *Lehndorff* suggests an application for consolidation may be brought at the same time as a request for an initial stay of proceedings. In that case, an interim standstill agreement had been worked out between the parties prior to the initial order, allowing the management to develop a consolidated restructuring plan. Therefore, the current approach appears to be flexible, taking into account the status of the administration in the particular case.

3.4.4 Notice of Application

As already noted, the case law has suggested in most *CCAA* cases an application for a consolidated plan of compromise or arrangement occurs *after* the debtor companies have received an initial order from the court. In these cases, the issue of notice appears to be relatively straightforward: it is unlikely the court will approve a plan whereby the affected parties have not received notice of the application and not voted on the plan. However, the issue of notice becomes slightly less straightforward when the application for consolidation is brought at the *same time* as an initial order.

In some *CCAA* cases, an application for an initial stay order has brought by the debtor without notice, on an *ex parte* basis.⁸² The practical reason why debtors choose to apply on an *ex parte* basis is because it prevents creditors from moving to realize on their claims.⁸³ In the case of *Fairview Industries* the six debtor companies expressed concern that if they were required to give notice of the application, it would give the secured creditor the opportunity to appoint a receiver, which could prevent the applicant from qualifying under the *CCAA*.⁸⁴ Therefore, the

⁸² Sarra, *Rescue*, *supra*, footnote 38 at page 55.

⁸³ *Ibid.*, page 55.

⁸⁴ *Fairview Industries*, *supra*, footnote 54 *per* Justice Glube at paragraph 20.

inquiry in relation to consolidation becomes, will the court grant a consolidation order in conjunction with an application for an initial order, on an *ex parte* basis?

The only case that is relevant in answering this matter is *Lehndorff*. In the case an application for consolidated was brought at the same time as the application for an initial order for a stay of proceedings, with notice to the various creditors. Justice Farley noted the court will be concerned when major creditors have not been alerted even in the most minimal fashion.⁸⁵ Therefore, given the potential impact the consolidation order can have on creditor rights, it seems unlikely the courts would grant a consolidation order on an *ex parte* basis or in conjunction with an initial order on an *ex parte* basis. However, this issue arguably remains a moot point and will be discussed later in Chapter 5.

3.4.5 Inclusion of Solvent Group Members

To be granted relief under the *CCAA* a debtor must be insolvent having debts greater than \$5 million.⁸⁶ Until recently, many believed the definition of insolvent in the *BIA* should apply to *CCAA* proceedings.⁸⁷ Section 2(1) *BIA* states:

“insolvent person” means a person who is not bankrupt and who resides, carries on business or has property in Canada, whose liabilities to creditors provable as claims under this Act amount to one thousand dollars, and

⁸⁵ *Lehndorff*, *supra*, footnote 58 *per* Justice Farley at paragraph 3.

⁸⁶ Sarra, *Rescue*, *supra*, footnote 38 at page 6. Section 2 *CCAA*. Section 2 of the *CCAA* defines a "debtor company" as any company that:(a) is bankrupt or insolvent, (b) has committed an act of bankruptcy within the meaning of the *Bankruptcy and Insolvency Act* or is deemed insolvent within the meaning of the *Winding-up and Restructuring Act*, whether or not proceedings in respect of the company have been taken under either of those Acts, (c) has made an authorized assignment or against which a receiving order has been made under the *Bankruptcy and Insolvency Act*, or(d) is in the course of being wound up under the *Winding-up and Restructuring Act* because the company is insolvent.

⁸⁷ Yalden, R., *et al*, *Business Organizations: Principles, Policies and Practice*, (Toronto, Emond Montgomery Publication, 2008), page 1187.

(a) who is for any reason unable to meet his obligations as they generally become due,

(b) who has ceased paying his current obligations in the ordinary course of business as they generally become due, or

(c) the aggregate of whose property is not, at a fair valuation, sufficient, or, if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable payment of all his obligations, due and accruing due.

However, the Ontario Superior Court in the case of *Stelco*⁸⁸ has stated “insolvent” should be given an expanded meaning under the *CCAA*.⁸⁹ Justice Farley held a financially troubled corporation is “insolvent if it is reasonably expected to run out of liquidity within a reasonable proximity of time as compared with the time reasonably required to implement a restructuring.”⁹⁰ Justice Farley acknowledged that under the “traditional” and more restrictive test laid down in section 2(1) *BIA* the debtor in the case, *Stelco*, would not be “insolvent.” Therefore, the new test laid down in *Stelco* indicates debtor companies can qualify for relief under the *CCAA* with a much broader and relaxed insolvency requirement.

To date there has not been a case that tests the scope of *Stelco* for the purposes of consolidation. However, given the wider scope of the term insolvent in *Stelco*, two assumptions can be made. Firstly, as DaRe notes, as long as there is at the time of filing, a “reasonably foreseeable

⁸⁸ *Stelco Inc., Re*, (2004), 2004 CarswellOnt 1211 48 C.B.R. (4th) 299 (Ont. S.C.J. [Commercial List]), [hereinafter *Stelco*].

⁸⁹ *Ibid.*, per Justice Farley at paragraph 25.

⁹⁰ *Ibid.*, per Justice Farley at paragraph 40.

expectation” of a liquidity problem,⁹¹ it seems likely a debtor company will fit under the CCAA insolvency umbrella for the purposes of consolidation. Secondly, despite the CCAA having a broad remedial purpose, it seems unlikely the courts will permit a “purely solvent” debtor to be included in an order for consolidation.

3.5 Conclusion

This Chapter embarked on a rigorous doctrinal analysis of the existing jurisprudence in order to gain a deeper understanding of how the remedy of substantive consolidation under the CCAA framework has evolved. With no statutory provisions, the Canadian courts have played a direct role in developing the principles relating to the remedy of substantive consolidation. Yet, the analysis indicates courts have primarily focussed on the factors supporting an order for substantive consolidation in the domestic context. As a result, the Chapter argues the current approach fails to provide the most appropriate framework for addressing key issues that stem from an application or order for substantive consolidation in the domestic context.

The Chapter indicates the principles articulated by Justice Glennie in *Atlantic Yarns* for determining the factors that support substantive consolidation ensures the remedy can be available in a variety of CCAA restructuring cases. However, the guidance fails to specify the test that should be adopted for establishing whether there is an intermingling of assets and liabilities.

The judicial dialogue surrounding the effects of consolidation lacks certainty and rigour. The courts have alluded to the potential prejudice to creditor rights from the levelling of recoveries. Yet, the courts have failed to provide any clear guidance on the array of issues that impact creditors’ rights.

⁹¹ DaRe, V., “Is ‘Insolvency’ Still a Prerequisite to Restructuring?,” (2004) 49 *Canadian Bankruptcy Reports*, (4th) 163.

The examination of the issues surrounding an application for substantive consolidation echoes the same concerns. The courts have failed to stipulate with clarity, if at all, the scope of the procedural requirements. Whilst the jurisprudence indicates that both debtor companies and creditors can bring an application for substantive consolidation, it has failed to stipulate whether the monitor or the court can act on its own initiative. It is unclear whether notice is a prerequisite to an application, particularly when an application for consolidation is brought at the same time as an *ex parte* application for an initial stay of proceedings order. The scope of the definition of “insolvent” laid down in *Stelco* has not yet been tested or discussed for the purposes of consolidation. Hence it has left open the question whether a solvent group member can be included in a consolidation order. However, the case law on the timing of applications for consolidation suggests the current approach is flexible: applications have been brought at various stages of the administration.

Having concluded in this Chapter the current judicial dialogue does not give guidance on the standard for determining a significant intertwining of assets and liabilities, the following Chapter examines an approach that should be adopted for the CCAA. Further, the alternative circumstance of the creditors relying upon the single economic unit in extending credit is considered.

Chapter 4: Factors Supporting Substantive Consolidation in the Domestic Context

4.1 Introduction

The doctrinal analysis in Chapter 3 revealed the Canadian courts continue to play a direct role in developing the factors that support an order for substantive consolidation in the context of the CCAA. The most recent case of *Atlantic Yarns* indicated the court will look towards three factors in determining whether to order substantive consolidation. Firstly, the court must determine whether the elements of consolidation are present, such as the significant intertwining of assets and liabilities.⁹² Secondly, there must be a balancing of interests, ensuring the benefits of consolidation will outweigh any prejudice to particular creditors.⁹³ Thirdly, it is appropriate to look at the overall effect of consolidation to ensure it is both fair and reasonable in the circumstances.⁹⁴

Yet, the reasoning in the case of *Atlantic Yarns* fails to specify what standard should be applied in determining whether there is a significant intertwining of assets and liabilities. Further, the current position has yet to consider other circumstances that are the key focus of Working Group V discussions and the United States jurisprudence, such as debtors that disregard their separateness to such an extent that creditors viewed them as one entity. Therefore, this Chapter takes issue with these two observations.

Accordingly, there are two parts to this Chapter. In the first section, the discussions by Working Group V on the standard to be applied for determining whether there has been an intermingling

⁹² *Northland Properties, supra*, footnote 40 per Justice Glennie at paragraph 34.

⁹³ *Ibid.*

⁹⁴ *Ibid.*, per Justice Glennie at paragraph 33 and 36.

of assets and liabilities are explored. In the second section, the circumstance of debtors disregarding their separateness to such an extent that creditors viewed them as one entity is explored in order to determine whether such an approach is desirable in the context of the CCAA. In doing so, the Working Group V discussions and the United States jurisprudence is closely examined.

4.2 The Intermingling of Assets and Liabilities

4.2.1 Working Group V Findings

The Working Group V literature⁹⁵ signifies three differing standards have been explored: (a) the “impossibility” of identifying the ownership of individual assets and responsibility for liabilities, (b) the ownership of assets and responsibility for liabilities cannot be identified “without undue cost and delay,” and (c) the ownership of assets and responsibility for liabilities cannot be identified “without disproportionate expense or delay.”

Initially it was proposed by the Secretariat the standard to determine whether there was an intermingling of assets and liabilities should be the “impossibility to disentangle” the ownership of individual assets and responsibility for liabilities.⁹⁶ However, the Working Group noted that the “impossibility” standard may create an extremely high threshold that in practice could be

⁹⁵ UNCITRAL Working Group V, Note by Secretariat, Document A/CN.9/WG.V/WP.76/Add.1, 14-18, May 2007, New York; UNCITRAL Working Group V, Note by Secretariat, Document A/CN.9/WG.V/WP.80/Add.1, 3-7, March 2008, New York; UNCITRAL Working Group V, Report of Working Group V (Insolvency Law) on the work of its thirty-fourth session, Document A/CN.9/647, 3-7, March 2008, New York; UNCITRAL Working Group V, Note by Secretariat, Document A/CN.9/WG.V/WP.82/Add.3, 17-21, November 2008, Vienna; UNCITRAL Working Group V, Report of Working Group V (Insolvency Law) on the work of its thirty-sixth session, Document A/CN.9/671, 18-22, May 2009, New York; UNCITRAL Working Group V, Report of Working Group V (Insolvency Law) on the work of its thirty-seventh session, Document A/CN.9/686, 9-13 November 2009, Vienna.

⁹⁶ UNCITRAL Working Group V, Note by Secretariat, Document A/CN.9/WG.V/WP.76/Add.1, 14-18 May 2007, New York, at paragraph 38.

difficult to prove. Therefore, the Secretariat noted the approach maybe unworkable, requiring an alternative to the standard of “impossible to identify” to be considered.⁹⁷

The call for pragmatism led the discussions of Working Group V to a standard with a lower threshold; individual ownership of assets and responsibilities of liabilities cannot be identified “without undue cost and delay.”⁹⁸ However, at its thirty-fourth session, Working Group V noted the meaning of the word “undue” was too uncertain and should be replaced with a concept of “disproportionality of expense and delay” to the amount that could be recovered for creditors or to the benefit to be derived from undertaking the identification.⁹⁹

Therefore, in September 2008 the Secretariat provided draft recommendations that reflected the standard of disproportionate expense or delay:¹⁰⁰

Where the court is satisfied that the assets or liabilities of the enterprise group members are intermingled to such an extent that the ownership of individual assets and responsibility for liabilities cannot be identified without disproportionate expense or delay.

However, further concerns were expressed about the scope of the standard of disproportionality.

Firstly, it was suggested at Working Group V’s thirty-sixth session the term disproportionate was

⁹⁷ UNCITRAL Working Group V, Note by Secretariat, Document A/CN.9/WG.V/WP.80/Add.1, 3-7 March 2008, New York at paragraph 8.

⁹⁸ *Ibid.*

⁹⁹ UNCITRAL Working Group V, Report of Working Group V (Insolvency Law) on the work of its thirty-fourth session, Document A/CN.9/647, 3-7, March 2008, New York.

¹⁰⁰ UNCITRAL Working Group V, Note by Secretariat, Document A/CN.9/WG.V/WP.82/Add.3, 17-21 November 2008, Vienna at paragraph 41.

considered too vague.¹⁰¹ Secondly, at Working Group V's thirty-seventh session, the term disproportionate was questioned on the basis that it implied a comparison that was missing.¹⁰² Nevertheless, the Working Group adopted the substance of the draft legislative recommendations that employs the standard of disproportionality of expense and delay."¹⁰³

4.2.2 Lessons for the CCAA

The Working Group V discussions are informative to the analysis of substantive consolidation under the CCAA. It signifies the need to rigorously examine the practical effects of any given approach and to ensure concepts used provide certainty and predictability. However, it is fundamental to situate the Working Group V findings within the framework of the CCAA.

Firstly, there is a difference in the terminology used in the Working Group V discussions and the jurisprudence on substantive consolidation under the CCAA. The Working Group V literature refers to the “intermingling of assets and liabilities” whilst the Canadian jurisprudence refers to the “intertwining of assets and liabilities.” However, since the terms are analogous, the Working Group V discussions remain useful. Further, the “ownership” of assets and the “responsibility” of liabilities are not terms used in the Canadian jurisprudence. Nevertheless, it is clear the Canadian position would benefit from adopting this more defined approach.

Secondly, whilst the Canadian jurisprudence indicates the “intertwining of assets and liabilities” is a key factor Canadian courts look towards when determining to grant an order of substantive

¹⁰¹ UNCITRAL Working Group V, Report of Working Group V (Insolvency Law) on the work of its thirty-sixth session, Document A.CN.9/671, 18-22 May 2009, New York at paragraph 104.

¹⁰² UNCITRAL Working Group V, Report of Working Group V (Insolvency Law) on the work of its thirty-seventh session, Document A/CN.9/686, 9-13, November 2009, Vienna, paragraph 102.

¹⁰³ *Ibid.*

consolidation under the *CCAA*, other features of “intertwining” also appear relevant to the enquiry. In the case of *PSINet* Justice Farley referred to the “intertwined nature of the applicants and their business operations, which businesses in essence operated as a single business.”¹⁰⁴

Furthermore, in the case of *Lehndorff*, his Honour noted the “business affairs of the applicants are significantly intertwined as there are multiple instances of intercorporate debt, cross-default provisions and guarantees and they operated a centralized cash management system.”¹⁰⁵

Accordingly, these cases indicate whilst the Working Group V discussions centre on assets and liabilities, the approach under the *CCAA* is much broader. As a result, it will be important to determine whether the same standard should apply to these additional factors or whether a separate standard should be adopted.

Finally, the three different standards presented by Working Group V each have to be examined in turn to ascertain what would be the most suitable for the scope of the *CCAA* framework.

It is clear from the Working Group’s discussion it would be wholly undesirable to impose an “impossibility” standard for identifying ownership of assets and responsibility of liabilities under the *CCAA* framework. In most cases, identification of ownership of assets and responsibility of liabilities can be obtained but it may result in a complex unravelling of financing transactions. Hence, the standard would impose a threshold that would be impractical to achieve. Further, if the standard was to apply to other features of intermingling, such as business functions and business operations the standard becomes even more redundant.

In contrast, the “without undue cost and delay” standard appears more suited to the *CCAA* framework. It recognises that in most cases, the identification of individual ownership of assets

¹⁰⁴ *PSINet*, *supra*, footnote 63 *per* Justice Farley at paragraph 2.

¹⁰⁵ *Lehndorff*, *supra*, footnote 58 *per* Justice Farley at paragraph 2.

and responsibility for liabilities will inevitably generate additional costs and delays to the administration of the restructuring proceedings. Yet, the Canadian courts have suggested in the context of the *BIA* increasing administrative ease is not enough to counteract the possible prejudice substantive consolidation can create for creditors.¹⁰⁶ As a result, although the “without undue cost and delay” approach provides a more practical threshold level in contrast to the “impossibility” approach, it does fail to attach more importance to the possible potential prejudice to any creditor than the interests of time, expense and expediency. Accordingly, with the need to ensure administrative ease is not the primary focus, it appears the “without disproportionate expense or delay” standard is most suited to the scope of the *CCAA*. It reflects the notion that courts will undertake a balancing of interests exercise, assessing whether the benefits will outweigh the prejudice to particular creditors if the proceedings are substantively consolidated. Further, should the standard be applied to other factors, such as business functions, it would be create an obtainable threshold in practice.

4.2.3 Summary

The analysis highlights the intermingling of assets and liabilities can be hard to quantify. The variety of approaches to the standard to be used to identify the ownership of individual assets and responsibility for liabilities further reflects this notion. However, in practice courts will look towards fact specific information to determine the degree of intermingling, such as how assets were transferred and the manner the group operated financially. Hence, the Working Group V discussions indicate although it is fundamental to have a clear criterion which judges assess the relevant issues against, the many factors courts take into account may not be easily prescribed on

¹⁰⁶ See *J. P. Capital Corp., Re*, (1995), 31 C.B.R. (3d) 102, 1995 CarswellOnt 53 (Ont. Bkcty.) Whilst this is governed under the *BIA*, it is informative to the discussion because it emphasises the courts reluctance to grant substantive consolidation on the grounds of expediency.

paper. Nevertheless, the standard of “without disproportionate expense or delay” appears most suited to the CCAA framework. It reflects the balancing of interests exercise Canadian courts undertake and provides a threshold that is practical.

4.3 Creditors Dealing with the Group as a Single Economic Unit

4.3.1 Introduction

The existing jurisprudence reveals the circumstances that can be relied on for the purpose of the CCAA does not include when debtors that disregard their separateness to such an extent that creditors viewed them as one entity. This approach has also been rejected by Working Group V because of its various practical difficulties, such as ascertaining the subjective minds of creditors at the time they entered into transactions with the member of the enterprise group.

However, Canada’s largest trading partner, the United States has adopted the approach. In the case of *re Owens Corning*,¹⁰⁷ the United States Court of Appeals for the Third Circuit noted substantive consolidation may be granted when prepetition period, the debtors disregarded their separateness to such an extent that creditors viewed them as one entity. Therefore, the section examines both the advantages and disadvantages outlined in the literature to discover whether the CCAA framework would benefit or be hindered from employing such an approach.

This section has three parts. Firstly, the Working Group V discussions on the matter are described. Secondly, the United States approach laid down in the case of *Owens Corning* is examined. Finally, the advantages and disadvantages for employing the single economic unit factor for the CCAA framework are discussed.

¹⁰⁷ *In re Owens Corning*, Docket No. 04-4080, 2005 U.S. App. LEXIS 17150 (3d Cir. 2005), reversing *In re Owens Corning*, 316 B.R.168 (D. De. 2004) [hereinafter, *Owens Corning*].

4.3.2 Working Group V Findings

Working Group V began examining the circumstance of creditors dealing with the entities as a single economic unity not relying on the separate identity in extending credit in January 2007.¹⁰⁸

In March 2007, the Secretariat formulated the first draft legislative recommendations on the matter as follows:

(b) the extent to which creditors had dealt with the members of an enterprise group as a single economic unit and did not rely upon their separate identity in extending credit.¹⁰⁹

In May 2007, at its thirty-second session, the Working Group V reviewed the initial draft recommendations.¹¹⁰ However, the concern was expressed that there would be difficulties encountered in ascertaining the minds of creditors at the time they entered into transactions with the member of the enterprise group. Therefore, the Working Group agreed the test should refer to a majority or significant number of creditors.

Accordingly, in August 2007 the Secretariat revised the recommendations to reflect this view as follows:

18(a) Creditors had dealt with the members of a group as a single economic unit and did not rely upon the separate identity of members in extending credit.¹¹¹

¹⁰⁸ UNCITRAL Working Group V, *supra*, footnote 5 at paragraph 36.

¹⁰⁹ UNCITRAL Working Group V, *supra*, footnote 96 at paragraph 38.

¹¹⁰ UNCITRAL Working Group V, Report of Working Group V (Insolvency Law) on the work of its thirty-third session, Document A/CN.9/643, 5-9 November 2007, Vienna at paragraph 76.

¹¹¹ UNCITRAL Working Group V, Note by Secretariat, Document A/CN/WG.V/WP78/Add.1, 5-9 November 2007, Vienna at paragraph 19.

However, the Secretariat noted no qualifying element was added on to the recommendations at this stage to reflect whether a sufficient number of creditors relief on the single economic unity to justify an order for consolidation but may want to be considered further by Working Group V.¹¹²

In November 2007, at Working Group V's thirty-third session, the view was expressed that the drafting was too broad and the focus of the recommendation was the subjective views of creditors, rather than the objective behaviour of the group that had led creditors to believe that they were dealing with a single entity.¹¹³ As a result, it was agreed the focus should be on the behaviour of the group as a single entity.

In January 2008, the Secretariat revised the draft recommendations to reflect this change as follows:

(c) Where the court is satisfied that the enterprise group presented itself as a single enterprise or otherwise behaved in a manner that encouraged third parties [to deal with it as a single enterprise][to believe they were dealing with a single enterprise] [and blurred the legal boundaries between group members.].¹¹⁴

In the commentary, the Secretariat noted three detailed features of the draft legislative recommendations. Firstly, the focus of the text is on behaviour of the enterprise group that has given creditors a deceptive appearance of unity, leading them to believe they were dealing with a

¹¹² *Ibid.*, at paragraph 22.

¹¹³ UNCITRAL Working Group V, *supra*, footnote 110 at paragraph 76.

¹¹⁴ UNCITRAL Working Group V, *supra*, footnote 111 at paragraph 1.

single entity rather than with different members of a group.¹¹⁵ The Secretariat noted Working Group should consider whether this behaviour should be limited to fraudulent behaviour or might include situations such as bad management.¹¹⁶

Secondly, the Secretariat outlined a list of factors relevant to determining whether the circumstance has been satisfied. This included; (a) how the group promoted its public image through advertising, marketing and correspondence generally; (b) financial arrangements, such as payment of invoices to one group member by other group members or payment of invoices to a number of group members by one group member; (c) commonality of directors and company secretaries between members of the group; (d) the use of a single bank account for all members; treatment of creditors of one group member as if they were creditors of other group members or of the group more generally, so that creditors lost their connection with specific debtors; and (e) confusion with respect to the treatment of employees, in particular with respect to the identity of the employing entity. However, the Secretariat noted that while many of these factors are commonplace occurrences within an enterprise group, they would only provide grounds for substantive consolidation in limited circumstances where reasonable due diligence on the part of creditors would not have ascertained the identity of the entity that they were dealing.¹¹⁷

Thirdly, the Secretariat suggested that consideration must be given to the time at which the behaviour took place, as it might have changed over time and with respect to different creditors.¹¹⁸ Yet, despite the useful commentary, Working Group V agreed at its thirty-fourth

¹¹⁵ *Ibid.*, at paragraph 12.

¹¹⁶ *Ibid.*

¹¹⁷ *Ibid.*, at paragraph 13.

¹¹⁸ *Ibid.*, at paragraph 14.

session, the provision did not meet the objectivity standard and should be deleted. It was observed that the concepts of appearance and reliance might give rise to other remedies and should not lead to the remedy of substantive consolidation.¹¹⁹

4.3.3 The Approach in the United States

4.3.3.1 Justifications for a Comparative Analysis

An examination of United States approach is informative to the analysis under the CCAA framework for three reasons. Firstly, in Chapter 3, the doctrinal analysis indicated the remedy of substantive consolidation is a legal transplant from the United States. In the primary case of *Northland Properties* Justice Trainor relied on United States jurisprudence as authority for the proposition that substantive consolidation could apply in certain circumstances. Secondly, since the United States is Canada's largest trading partner, a significant number of cross-border restructuring cases can occur between the two jurisdictions. Therefore, there is potential for the doctrine of substantive consolidation under the CCAA framework to be important in some cross-border cases. Thirdly, there are key similarities between the two jurisdictions. Analogous to the position under the CCAA, the United States *Bankruptcy Code*¹²⁰ does not expressly authorise substantive consolidation. The United States Bankruptcy Courts rely on their broad equitable powers conferred in section 105(a) of the *Bankruptcy Code* to grant such orders.

4.3.3.2 Owens Corning

¹¹⁹ UNCITRAL Working Group V, *supra*, footnote 99.

¹²⁰ United States, *Bankruptcy Code*.

The recent case of *Owens Corning*¹²¹ has firmly set the parameters of the factors that may support an order for substantive consolidation. The Third Circuit noted whereby (i) the parties consent; (ii) the prepetition period, the debtors disregarded their separateness to such an extent that creditors viewed them as one entity; or (iii) during the post petition period, the debtors' assets were so intertwined that separating the assets would be impossible or would hurt all creditors.¹²² Further, the Third Circuit noted it must be proved in prepetition conduct: (i) there was a corporate disregard, creating contractual expectations of creditors that they were dealing with the debtors as one indistinguishable entity; and (ii) the creditors actually and reasonably relied on the debtors' alleged unity.

The case of *Owens Corning* is significant since the Third Circuit has limited the factor of debtors disregarding their separateness to such an extent that creditors viewed them as one entity to creditors with claims based on contractual rights only. The practical effect is tort and statutory claimants as "involuntary creditors" are excluded.¹²³ This strict approach reiterates the need to ensure the remedy is a constrained tool to be used in limited circumstances.

4.3.4 Lessons for the CCAA

The Working Group V literature and the United States jurisprudence relating to debtors disregarding their separateness to such an extent that creditors viewed them as one entity has various practical considerations that must be closely observed in the context of the CCAA.

Firstly, there needs to be a clear test for determining whether the debtors disregarded their separateness to such an extent that creditors viewed them as one entity. The Working Group V

¹²¹ *Owens Corning, supra*, footnote 107.

¹²² *Ibid.*, at 211.

¹²³ *Ibid.* See footnote 21 of *Owens Corning* judgement at <http://www.ca3.uscourts.gov/opinarch/044080p.pdf>.

literature indicated two approaches that can be applied; (a) the subjective minds of the creditors, or (b) the objective behaviour of the group members. However, the Working Group V discussions also expose the difficulties that may be encountered with both approaches. The subjective approach creates practical difficulties for courts in examining how the subjective minds of creditors and at what time in the transaction this will occur. The objective approach that centres on the behaviour of the group also presents complex practical issues, namely what type of behaviour the courts must look towards. The Secretariat of Working Group V provided various example factors courts could consider. This included: public image, financial arrangements, commonality of company officers, the use of a single bank account, treatment of creditors of one group member as if they were creditors of other group members or of the group more generally, and confusion with respect to the treatment of employees. Nevertheless, the Third Circuit in the case of *Owens Corning* has yet to indicate how courts would proceed to answer this inquiry.

However, given the need to ensure there is a balance between flexibility and certainty in the CCAA framework, it is fundamental the types of behaviour will be broad enough to cover a variety of restructuring cases but provides clear guidance for stakeholders. The timing of the behaviour also requires further reflection. Should the behaviour occur prior to the transaction or at the time of the transaction?

The Working Group V discussions indicated that due diligence by creditors can be seen as a double edge sword. On one hand, creditors should enquire into the composition of the debtor to ensure the remedy of substantive consolidation is only used in limited circumstances. On the other hand, in some cases, due diligence may be a complex and convoluted enquiry that may be particularly hard for certain types of creditors, such as employees.

The United States Third Circuit decision of *Owens Corning* demonstrates the factor can be restricted to creditors with contractual expectations only, excluding non-contractual creditors such as tort claimants. This approach is well suited in the United States whereby trust funds have been created as a mechanism to satisfy mass tort claims.¹²⁴

Under the CCAA framework, tort claimants are considered as a “creditor” so long as it can be established there is a provable claim.¹²⁵ In most cases, tort claimants will be subject to the stay of proceedings in the initial order and have the opportunity to vote on a plan of compromise or arrangement accordingly. The case of *Red Cross*¹²⁶ was the first CCAA case to consider the position of tort claimants as key creditors. The plan of compromise and arrangement provided for a trust fund of approximately \$79 million to compensate persons infected with disease as a result of transfusion of blood or blood products.¹²⁷ Therefore, the case of *Red Cross* suggests restricting substantive consolidation to creditors with contractual claims only may not drastically jeopardise the position of tort claimants in cases whereby there is a trust fund mechanism available to satisfy such claims. However, two observations must be observed. Firstly, there is no codified language in the CCAA that ensures trust funds are employed to satisfy tort claims. Hence excluding tort claimants may not be permissible in all cases. Secondly, even where trust funds do exist, as Sarra notes, it may be difficult to determine *ex ante* the amount of trust funds required to be set aside for the future satisfaction of claims, when no one really knows the full manifestation of the harms that arise.¹²⁸ However, since it is extremely rare tort claimants have acted as lenders, it seems unlikely they would need to consider the composition of the

¹²⁴ Sarra, *Rescue*, *supra*, footnote 38 at page 227.

¹²⁵ *Ibid.*

¹²⁶ *Re Canadian Red Cross Society*, (2000), 19 C.B.R. (4th) 158; [2000] O.J. No. 3421 (Q.L.)(O.S.C.J.).

¹²⁷ *Killough et al v. Canadian Red Cross et al.*, 2001 BCSC 1060.

¹²⁸ Sarra, J. P., *Creditor Rights and the Public Interest: Restructuring Insolvent Corporations*, (Toronto: University of Toronto Press, 2003 at page 212.

corporation to lend or extend credit terms. Nevertheless, the considerations surrounding the trust fund vehicle requires further research.

4.3.5 Summary

The Working Group V literature and the United States jurisprudence reveals there are various practical considerations relating to debtors disregarded their separateness to such an extent that creditors viewed them as one entity. The analysis indicates practical difficulties occur with both the subjective and objective tests proposed.

Further, limiting the factor to claimants with contractual claims demands careful consideration of the position of all involuntary creditors. This Chapter analyzed the position of tort claimants under the *CCAA*. It argues there are various issues surrounding the use of trust funds to satisfy such claim that require careful consideration. However, since in most *CCAA* cases there is no practical need to consider the composition of the company for lending purposes, restricting the factor to contractual claims only appears workable.

4.4 Conclusion

In conclusion, the current approach to the circumstances supporting consolidation under the *CCAA* fails to provide clear guidance on what standard should be applied in determining whether there has been an intermingling of assets and liabilities. Informed by the discussions of Working Group V, this Chapter argues the most appropriate standard for the *CCAA* framework is “without disproportionate expense or delay” that could be applied not only the intermingling of assets and liabilities but other factors such as business operations. Nevertheless, the inquiry will inevitably be fact evasive, courts taking into account the entirety of the business in determining whether to grant substantive consolidation.

This Chapter also considered an alternative approach of debtors disregarding their separateness to such an extent that creditors viewed them as one entity. Informed by the discussions of Working Group V and the United States jurisprudence, this Chapter argues the objective test for determining how debtors disregard their separateness is the most suitable for the *CCAA* framework should the circumstance be adopted. However, the type of behaviour this will include and at what time in the transaction between the debtor and creditor requires careful consideration. Further, limiting the use of the circumstance to contractual claims needs careful consideration. This Chapter argues although the position of tort claimants under the *CCAA* is not drastically jeopardised, the notion of trust funds and other involuntary creditor groups demands consideration.

The following Chapter examines the UNCITRAL Working Group V discussions relating to the key issues stemming from an application for substantive consolidation in the domestic context to determine how the current position could be improved.

Chapter 5: Application for Substantive Consolidation in the Domestic Context

5.1 Introduction

The review of the existing jurisprudence in Chapter 3 indicated the Canadian courts have failed to provide little guidance, if any, on the issues relating to an application for substantive consolidation under the *CCAA* in the domestic context. Firstly, it is unclear whether the monitor can bring an application for substantive consolidation or if the court can grant such an order on its own initiative. Secondly, although the current approach to the timing of an application appears flexible, the courts have yet to identify why this approach has been adopted. Thirdly, questions still remain unanswered in relation to notice of an application. Is notice a prerequisite to an application? When and to whom should notice be provided? Finally, the courts have yet to consider whether a solvent enterprise group member should be included in an application for substantive consolidation. Therefore, this Chapter investigates how the current framework could be enhanced by drawing upon the conclusions of Working Group V to propose a variety of policy options in relation to the four key issues identified. This chapter has four sections, tackling each in turn.

5.2 Persons Permitted to Apply for Substantive Consolidation

5.2.1 Introduction

The review of the existing case law in Chapter 3 indicated that in most cases, an application for substantive consolidation under the *CCAA* is brought by the debtor at the time of requesting the court to sanction a consolidated plan of compromise or arrangement under section 6(1) *CCAA*. However, the case of *Fairview Industries* also highlighted in some cases an application for substantive consolidation may be brought the creditors. Yet, the *CCAA* statutory framework and

the six reported cases fail to indicate whether an application for substantive consolidation can be brought by the *monitor* or by the *court* acting on its own initiative. Therefore, this section explores whether the current approach would benefit from the monitor or the court being permitted to bring applications for substantive consolidation.

5.2.2 The Monitor

As part of the initial order, the court will appoint a monitor to supervise the business and financial affairs of the debtor company whilst in the *CCAA* proceedings.¹²⁹ The monitor, as a court appointed officer, acts as “the eyes and ears” of the court. The monitor will oversee the ongoing operations of the debtor, assist with the filing and voting of the plan of compromise or arrangement and report to the court on the practicality of the plan. The monitor also acts independently and impartially in the interest of all stakeholders in the *CCAA* proceedings.

In practice, the role of the monitor has expanded in scope in recent years. Knowles notes the role of the monitor, now as a matter of course, goes beyond simply providing information to the court regarding the business and financial affairs of the company and providing recommendations to the court.¹³⁰ The role of the monitor can include reporting to secured creditors, selling assets with secured creditor approval and negotiating with various stakeholders.

These duties are set out in the *CCAA*. Section 23 *CCAA* notes the monitor’s duties include; (a) reviewing the company’s cash flow statements,¹³¹ (b) filing a report to the court on the state of

¹²⁹ *CCAA* section 11.7.

¹³⁰ Knowles, D., “To Liquidate or Restructure under the *CCAA*? The Monitor’s Conflicting Duties,” in Sarra, J. P., ed., *2006, Annual Review of Insolvency Law*, (Toronto: Carswell, 2006) at page 95 -100.

¹³¹ *CCAA* section 23(1) (b).

the company's business and financial affairs,¹³² (c) advising the company's creditors of the filing of the report¹³³ and (d) advising the court on the reasonableness and fairness of any compromise or arrangement that is proposed between company and its creditors.¹³⁴ Further, section 23(1)(k) CCAA permits the monitor to carry out any other functions in relation to the company that the court may direct.¹³⁵

The broad and pragmatic scope of section 23(1)(k) CCAA clearly recognises the need to ensure the monitor can continue to undertake any practical function that will add benefit to the restructuring process that lies in the interests of all stakeholders. Therefore, section 23(1)(k) CCAA provides the gateway to permit the monitor to bring applications for substantive consolidation in future CCAA proceedings. However, it is important to carefully consider the advantages and disadvantages of such an approach and whether it is desirable given the scope of the CCAA.

5.2.3 Advantages and Disadvantages

In most CCAA cases the monitor will possess the most complete information regarding the restructuring of the debtor company and any issues that may arise in relation to it. Therefore, the clear advantage of the monitor being permitted to make the application for substantive consolidation stems from the monitor's ability to assess the appropriateness of such an order with an array of information available that may not be possessed by other parties privy to the proceedings.

¹³² CCAA section 23 (1) (d).

¹³³ CCAA section 23(1) (e).

¹³⁴ CCAA section 23 (1) (i).

¹³⁵ CCAA section 23(1) (k).

When this issue was considered by UNCITRAL Working Group V the benefits of such an approach were clearly noted. At its thirty-third session, the Working Group noted since it is often the insolvency representative¹³⁶ who would be in the best position to apply for a consolidation order, possessing the most complete information about the debtor companies necessary to assess the desirability of substantive consolidation, insolvency representatives should be permitted to apply.¹³⁷ This view was later embodied in the draft legislative recommendations as follows:¹³⁸

Persons permitted to apply

223. The insolvency law should specify the persons permitted to make an application for substantive consolidation, which may include an enterprise group member, the insolvency representative of an enterprise group member or a creditor of any such group member.

Yet, despite the clear advantages in extending the role of the monitor to include bringing an application for substantive consolidation, it is fundamental it does not create a conflict of interest. The monitor must remain independent and impartial throughout the CCAA process. In *Re Stokes Building Supplies Ltd*¹³⁹ the Court noted that since tremendous reliance is placed on the views and recommendations of the monitor in the CCAA process, it is vital neither shareholders nor creditors have any influence over the monitor.¹⁴⁰ Further, in the case of *Siscoe*

¹³⁶ The term “insolvency representative” is not defined in the UNCITRAL Working Group V literature. However, it is presumed for the purpose of this discussion the term would cover the role of the monitor under the CCAA.

¹³⁷ UNCITRAL Working Group V, *supra*, footnote 110 at paragraph 82.

¹³⁸ UNCITRAL Working Group V, *supra*, footnote 37 at paragraph 15.

¹³⁹ *Stokes Building Supplies Ltd., Re*, (1992), 13 C.B.R. (3d) 10 (Nfld. T.D.).

¹⁴⁰ *Ibid.*, at paragraph 15.

*and Savoie v. Royal Bank*¹⁴¹ the New Brunswick Court of Appeal noted the monitor has a fiduciary obligation to all creditors to ensure that one creditor is not given an advantage over any over creditor.¹⁴² But the nature of substantive consolidation, the pooling of assets and liabilities to create one single insolvency estate, may cast some doubt over the ability of the monitor to fulfill its duties without conflict. The monitor may be seen to be acting in the interests of only those creditors who gain an increase in recoveries over those who may see a diminished return.

Nevertheless, there are two principal safeguards against any potential conflict of interest issues. Firstly, section 6(1) CCAA provides a plan of compromise or arrangement has to be voted on by creditors prior to an application for court approval. Therefore, given that in most cases an application for substantive consolidation is brought when seeking the court to sanction the plan of compromise or arrangement, all creditors would have voted on such a proposal. As a result, it seems difficult to challenge the monitor's application on grounds of acting in the interest of one creditor over another. In practice, any contested issue regarding the plan of compromise or arrangement will centre on the fairness and reasonableness of the plan or the voting procedures used. This was demonstrated in the case of *Atlantic Yarns* whereby the secured creditor brought a motion challenging the application for substantive consolidation by the debtor companies on the basis that the voting procedure set out in relation to the plan was unfair and unreasonable.

Secondly, section 23(1)(k) CCAA underlines the fact that the extension of the monitor's role is at the discretion of the court. Therefore, if the application jeopardised the monitor's ability to

¹⁴¹ *Siscoe and Savoie v. Royal Bank*, (1994), 29 C.B.R. (3d) 1 (N.B.C.A.).

¹⁴² *Ibid.*, at paragraph 8.

remain impartial and independent throughout the *CCAA* process, the court would not permit the monitor to carry out such a function.

Therefore, it appears the advantages of the monitor making an application for substantive consolidation outweigh the potential for conflict of interests. The monitor is likely to possess the most complete information regarding the debtor companies necessary to assess the desirability of substantive consolidation. Furthermore, section 23(1)(k) *CCAA* makes clear that the extension in the monitor's role is discretionary. The court will only allow the monitor to make an application on the basis that it does not create any conflict of interest.

5.2.4 The Court

The role of the court in *CCAA* proceedings is primarily supervisory in nature. The court serves to approve the framework for negotiation, determine matters that will facilitate the process and has overall responsibility to ensure the statutory requirements are met.¹⁴³ Yet, in recent years the courts have continued to make both substantive and procedural determinations regarding the restructuring process.¹⁴⁴ In doing so, it relies on section 11 *CCAA* to exercise its jurisdiction to make any order it considers appropriate in the circumstances. Therefore, this section examines whether it is desirable for courts to employ section 11 *CCAA* to grant substantive consolidation on its own initiative.

¹⁴³ Sarra, *Rescue*, *supra*, footnote 38 at page 60.

¹⁴⁴ In recent years the courts have relied on section 11 *CCAA* to introduce debtor in possession financing and broaden the definition of insolvent.

5.2.5 Fair and Equitable Process

The CCAA is focussed on providing a fair and equitable process with respect to devising a plan of compromise or arrangement between the debtor company and its creditors. Section 6(1) CCAA provides that in order for compromises to be sanctioned by the court, creditors have to vote in favour of the plan in the requisite statutory amounts.¹⁴⁵ Section 6(1) CCAA requires the court to; (a) critically examine whether there has been strict compliance with statutory requirements, (b) ensure all materials are filed and procedures carried out and (c) determine whether the plan is fair and reasonable. Therefore, given the serious impact substantive consolidation can have on creditor's rights, it seems vastly inappropriate for the court to sanction consolidation without following the fair and equitable process laid down in the statutory framework.

When this issue was examined by UNCITRAL Working Group V, it was agreed the court should not be able to act on its own on such matters of gravity.¹⁴⁶ The key reason stemmed from the need to ensure parties had the opportunity to be heard and object to such an order.¹⁴⁷ Therefore, although section 11 CCAA appears to provide an open door for courts to grant orders as it sees fit, it would be wholly undesirable for the court to take such action in relation to substantive consolidation.

¹⁴⁵ CCAA section 6(1).

¹⁴⁶ UNCITRAL Working Group V, *supra*, footnote 100 at paragraph 24.

¹⁴⁷ UNCITRAL Working Group V, *supra*, footnote 37 at paragraph 15.

5.3 Timing of Application

5.3.1 Introduction

The existing case law on substantive consolidation under the CCAA indicated that current approach to the timing of an application is flexible. In most cases, applications for substantive consolidation are made after the initial order, at a subsequent hearing whereby the debtor companies are requesting the court to sanction a consolidated plan of compromise or arrangement.¹⁴⁸ However, in some cases it may be impossible for the court to grant substantive consolidation at this stage of the proceedings due to the state of the administration of the insolvency estates. Therefore, applications for substantive consolidation can occur earlier, such as at the time of the initial order, as seen in the case of *Lehndorff*. However, the aim of this section is to determine whether the current flexible approach is the most desirable in practice or whether a more rigid approach to the timing of applications is demanded.

5.3.2 Flexibility to Meet Practical Demands

The key advantage to the current flexible approach to the timing of an application stems from its potential to ensure the remedy of substantive consolidation is widely available in a variety of restructuring cases.

Yet some commentators argue a more rigid approach to the timing of an application for substantive consolidation is desirable. Rotsztain and De Cicco argue an application should be made *no later than at the time of filing of the CCAA plan*.¹⁴⁹ They argue it would ensure the issue is adequately addressed prior to the debtor companies going to the expense of distributing the

¹⁴⁸ See the cases of *Northland Properties*, *Fairview*, *PSINet*, *Global Light* and *Atlantic Yarns*.

¹⁴⁹ Rotsztain and De Cicco, *supra*, footnote 29.

plan to creditors, convening a creditor's meetings to vote on the plan and avoiding the intense pressure to have the court approve the plan and permit its implementation.¹⁵⁰

However, it is argued the strict approach is not suitable for the *CCAA* for two key reasons. Firstly, as noted by UNCITRAL Working Group V, in some cases the factors supporting consolidation may not be certain or apparent at the time insolvency proceedings commence.¹⁵¹ Therefore, a rigid approach can create a missed opportunity for employing a consolidated plan of compromise or arrangement. It has the potential to hinder the restructuring process by preventing a consolidated plan of compromise or arrangement to be devised at the time most suitable in the circumstances.

Secondly, the statutory language of the *CCAA* acknowledges the need for flexibility. Section 6(2) *CCAA* permits creditors to modify the plan of compromise or arrangement *at the meeting of creditors* to vote on the proposed plan. Section 7 *CCAA* notes that where the change is made *after a meeting* at which creditors have voted on a plan, the court can proceed using its discretion to sanction the plan without creditors voting if it feels no party is adversely affected. Further, most plans of compromise or arrangement provide for a “comeback” clause, entitling the creditors or the debtor to return to court to modify an existing agreement.

Therefore, the flexible approach to the timing of an application for substantive consolidation reflects the practical need to ensure the remedy is available at any given moment in the restructuring process. Restrictions on the timing of an application would negatively impact the

¹⁵⁰ *Ibid.*

¹⁵¹ UNCITRAL Working Group V, *supra*, footnote 37 at paragraph 155.

core purpose of the CCAA; devising a plan of compromise or arrangement that enables the debtor to continue business but ensuring creditors receive some form of payment for the amounts owing to them.

5.4 Notice of the Application

5.4.1 Introduction

It is unclear from the existing case law whether notice is a prerequisite to an application for substantive consolidation, particularly when the application is brought at the same time as an *ex parte* application for an initial stay of proceedings. Although the case of *Lehndorff* suggested the court will be concerned when major creditors have not been alerted even in the most minimal fashion,¹⁵² the issues surrounding *when* notice should be provided remains unresolved. Further, the courts have also failed to provide any clear guidance on *who* should be provided notice of an application. Should all creditors of the debtor companies be given notice, or only specific groups of creditors, such as secured creditors? Furthermore, should creditors of both insolvent and solvent debtor companies be provided notice? This section seeks to answer these questions.

5.4.2 When to Give Notice

Given the extraordinary nature of substantive consolidation and the need to ensure procedural fairness is observed throughout the CCAA process, the Canadian courts have not approved a motion for substantive consolidation on an *ex parte* basis. Notice of an application provides creditors the opportunity to assess the application with respect to their position.

¹⁵² *Lehndorff, supra*, footnote 58 *per* Justice Farley at paragraph 3.

Yet, providing notice to all creditors at all times in the proceedings may disadvantage the debtor company that wants to obtain a substantive consolidation order in conjunction with an initial order on an *ex parte* basis since it provides creditors the opportunity to realise on their security. Nevertheless, the case of *Lehndorff* indicates it is unlikely the courts would grant a consolidation order on an *ex parte* basis or in conjunction with an initial order on an *ex parte* basis. It is vital creditors can review their positions in light of the proposed consolidation that may be favourable or unfavourable depending on the levelling of recoveries gained from using the remedy.

5.4.3 Notice to All Creditors or Specific Creditor Groups of the Debtor

The relevant *CCAA* statutory provisions indicates for most applications that alter the substantive rights of creditors state that notice only has to be provided to secured creditors. For example, section 11.2 *CCAA* provides that an application by a debtor for interim financing must provide notice to secured creditors who are likely to be affected by the security or charge. Section 11.51(1) *CCAA* indicates that on an application by a debtor company for security or charge relating to director's indemnification notice must be given to secured creditors who are likely to be affected by the security or charge. Therefore, should a similar approach be adopted for applications for substantive consolidation?

It is argued notice must be provided to all creditors groups for two principal reasons. Firstly, secured creditor claims are usually carved out and excluded from a consolidation order. Therefore, it is usually only the claims of priority and unsecured creditors that are the foundation of the consolidated insolvency estate. Secondly, even in cases whereby the encumbered

assets of the secured creditor are needed for restructuring, the secured creditor can surrender its security interests following the consolidation and the debt can be paid by the consolidated insolvency estates.

5.4.4 Notice to Creditors of Solvent Debtors

The issue of notice to creditors of solvent entities raises fundamental questions concerning the scope of the CCAA. On one hand, the case of *Stelco* indicates that the CCAA framework is only available to debtors that meet the definition of “insolvent,” a debtor who is “reasonably expected to run out of liquidity within a reasonable proximity of time as compared with the time reasonably required to implement a restructuring.”¹⁵³ Therefore, on this basis, the CCAA does not appear to envisage creditors of a purely solvent debtor to be provided notice. On the other hand, the potentially dramatic effect substantive consolidation can have on creditor rights demands that notice of an application is provided to the creditors of the solvent entity to assess their position accordingly. This approach also upholds the notion of equal treatment of creditors to solvent and insolvent entities.¹⁵⁴

Furthermore, the issue also raises crucial practical considerations. Providing notice of an application to the creditors of a solvent debtor could affect the commercial standing of that entity.¹⁵⁵ In practical terms, providing notice may result in a lack of confidence by its investors and creditors, potentially resulting in further financial instability.

¹⁵³ *Stelco*, *supra*, footnote 88.

¹⁵⁴ *Ibid.*, at paragraph 85.

¹⁵⁵ UNCITRAL Working Group V, *supra*, footnote 110 at paragraph 85.

However, the discussion of notice to creditors of solvent entities must be carefully considered in light of the inclusion of solvent group member in an application for substantive consolidation. If solvent entities are to be included in a consolidated plan or compromise or arrangement, the issue of notice becomes more pertinent. Accordingly, this discussion follows in the next section.

5.5 Inclusion of Solvent Group Member

5.5.1 Introduction

The definition of “insolvent” for the purpose of the *CCAA* was broadened in the case of *Stelco* but has yet to be examined by the courts for the purposes of substantive consolidation. As a result, it remains unclear whether a solvent group member could be included in an application for substantive consolidation. Hence this section carefully considers both the practical effects of inclusion and if it is within the scope of the *CCAA*.

5.5.2 Practical Effects

In cases where an insolvent debtor acts as one arm of the business operations and the solvent debtor acts as the other, consolidating the two entities can create financial stability to both companies. In particular it may prevent the liquidation of the insolvent debtor company.

Therefore, including a solvent group member in an application for substantive consolidation can help craft a successful restructuring plan that takes into account the *total* business operations of the group.

Yet, the inclusion of a solvent group member can have potentially drastic effects on creditors’ rights. In the case whereby the solvent debtor has more assets than liabilities to contribute to the consolidated insolvency estate, it will create a deeper levelling of creditor recoveries by vastly

varying the pool of assets available for distribution between creditors. It could decrease the recoveries of creditors of the solvent group member but increase the recoveries of other creditors, such as those of the insolvent group member. Therefore, creditors of the solvent group member may have particular concerns about these significant consequences of the consolidation. Therefore, it is important the consolidation order only extends to the net equity of the solvent group member in order to protect the rights of those creditors.¹⁵⁶ The practical effect is that certain encumbered assets or claims may have to be excluded from the consolidation.

Therefore, although the inclusion of a solvent group member may appear to provide better financial stability to the total group operation, creditors of the solvent group member may be reluctant to participate in the consolidation without protection for their position. As a result, a limited approach may have to be adopted.

5.5.3 The Scope of the CCAA

The requirement a debtor must meet the definition of “insolvent” laid down in the case *Stelco* in order to seek protection under the CCAA makes it unlikely the courts will permit a solvent enterprise group member to be included in an application for substantive consolidation. Although the CCAA is a broad remedial statute that gives the courts a high degree of discretion to be creative and flexible in the approach taken to restructuring, permitting a solvent enterprise group member to be included on an application would be outside the scope of the CCAA.

Nevertheless, the broader definition of “insolvent” from the case of *Stelco* can be seen to provide the courts with a useful stepping stone. As long it can be proven at the time of filing there is a

¹⁵⁶ UNCITRAL Working Group V, *supra*, footnote 100 at paragraph 36.

“reasonably foreseeable expectation” of a liquidity problem¹⁵⁷ the debtor company could fit under the *CCAA* insolvency umbrella for the purposes of consolidation.

5.5.4 Summary

The inclusion of a solvent enterprise group member in an application for substantive consolidation is desirable in cases where the total group business operations will be negatively impacted if each group member is restructured individually. However, a limited approach may have to be adopted in cases where the consolidation creates a greater levelling of recoveries. The case of *Stelco*, albeit broadened the scope of “insolvent” for the purpose of the *CCAA*, reaffirms at present it remains unlikely a solvent group member could be included in application for consolidation. Nevertheless, it may be possible to fit under the umbrella of “insolvent” if a reasonably foreseeable liquidity problem can be proven.

5.6 Conclusion

In this chapter, four key issues relating to an application for substantive consolidation were examined. In doing so, the scope of the *CCAA* and the practical effect of various options were closely borne in mind. As a result, various conclusions have been drawn in relation to each.

This Chapter suggests there are clear advantages and safeguards to the monitor being permitted to make an application for substantive consolidation. In most cases, the monitor will possess the most complete information about the restructuring of the debtor companies to make an assessment to the desirability of such an order. Further, given that section 23(1) (k) *CCAA* provides that any extension in the role of the monitor is at the discretion of the court; any conflict of interest issue that may arise will be duly observed. In contrast, the Chapter argues the court

¹⁵⁷ DaRe, *supra*, footnote 91.

should not be able to grant an application for substantive consolidation on its own initiative. The fair and equitable statutory process under the *CCAA* for devising a plan of compromise or arrangement must be followed to ensure parties can assess their position in relation to the potentially drastic effects of the remedy.

The Chapter noted the current flexible approach to the timing of an application ensures the remedy is widely available in a variety of restructuring cases and at the time in the proceedings the factors supporting consolidation are present. The Chapter suggests a rigid approach has the potential to not only hinder the restructuring of a group but fails to take into account the inherent flexibility of the existing statutory provisions on modifications to plans of compromise or arrangement.

The Chapter argues notice of an application for substantive consolidation should be provided at all stages of the proceedings and to all creditor groups. Notice to all creditor groups is particularly important in cases whereby the secured creditor's claim is carved out or excluded from the substantive consolidation order.

The Chapter suggests the case of *Stelco* has reinforced the notion that any protection under the *CCAA* is only available to those debtors that meet the definition of insolvent. Therefore, providing notice to creditors of solvent group members seems outside the scope of the *CCAA*. Nevertheless, the broad definition of insolvent effectively creates a wider enough umbrella for notice and inclusion of group members to occur.

To this end, an application for substantive consolidation under the *CCAA* framework has various practical consequences that demand careful reflection. In the following Chapter, the use of

remedy of substantive consolidation in the cross-border context is examined, unravelling different issues that demand distinct solutions.

Chapter 6: Substantive Consolidation in the Cross-Border Context

6.1 Introduction

The issues surrounding an order for substantive consolidation in the cross-border context have yet to be addressed by the Canadian courts or the *CCAA* statutory provisions. The existing jurisprudence primarily focuses on the circumstances courts should look towards when granting an order for substantive consolidation in the domestic context. The *CCAA* cross-border provisions fail to recognize the existence of enterprise groups and the application of the remedy in the international context. Equally, there is limited literature available that explores the international dimensions of the doctrine. Hence, the current landscape portrays a picture of a black hole in the discourse to be had on the topic.

In recent years *CCAA* cross-border proceedings have become more frequent.¹⁵⁸ As a result, there is a practical need to facilitate the restructuring of enterprise groups in the cross-border context. That is to say, careful consideration and exercise of the remedy of substantive consolidation could enhance successful restructuring agreements between debtors and creditors. Therefore, this Chapter undertakes the difficult task of starting to fill the present void in the discourse.

This Chapter has two parts. In the first section the current legal landscape is described. It identifies that the *CCAA* cross-border provisions fail to recognise the existence of enterprise groups. Accordingly, the existing obligation on the court to cooperate to the maximum extent appears limited, potentially restricting substantive consolidation in cross-border cases. The practical difficulties posed by the use of substantive consolidation in the cross-border context are

¹⁵⁸ See the statistics provided by the Office of the Superintendent of Bankruptcy at http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/h_br01011.html. For example, the *CCAA Statistics in Canada* highlight for the first quarter of 2010 there has been a 200% increase in the number of foreign main proceedings filed and 50% increase in the number of foreign non main proceedings filed compared to the last quarter of 2009.

also described. These include; the extraordinary nature, language and information barriers and varying approaches to insolvency and cross-border cases.

Having determined this landscape fails to provide an appropriate framework for the use of substantive consolidation in the cross border context, the second section investigates how the position could be improved. Informed by the Working Group V literature and dominant principles of Canadian cross-border insolvency law, the Chapter suggests the first step in improving the current position is to extend the obligation of cooperation to include enterprise groups.

6.2 The Current Legal Landscape

The current *CCAA* cross-border provisions, modelled on the UNCITRAL Model Law on Cross Border Insolvency,¹⁵⁹ recognises the need to facilitate cross-border restructuring proceedings by offering various mechanisms and obligations to promote; (a) the cooperation between the courts, greater legal certainty for trade and investment, (b) the fair and efficient administration of cross-border insolvencies that protects the interests of creditors and other interested persons, and those of debtor companies, (c) the protection and the maximization of the value of debtor company's property and (d) the rescue of financially troubled businesses to protect investment and preserve employment.¹⁶⁰ Firstly, a foreign representative¹⁶¹ is permitted to apply to the Canadian court

¹⁵⁹ The UNCITRAL Model Law on Cross-Border Insolvency Law 1997 was enacted into both *CCAA* and the *BIA*. For full text of the Model Law see: <http://www.UNCITRAL.org/pdf/english/texts/insolven/insolvency-e.pdf>. [Hereinafter UNCITRAL Model Law on Cross-Border Insolvency Law].

¹⁶⁰ *CCAA* section 44(1).

¹⁶¹ *CCAA* section 45 A foreign representative is defined in Section 45(1) *CCAA* as defined as a person or body, including one appointed on an interim basis, who is authorized, in a foreign proceeding respect of a debtor company, to (a) monitor the debtor company's business and financial affairs for the purpose of reorganization; or (b) act as a representative in respect of the foreign proceeding.

for recognition of a foreign proceeding.¹⁶² Secondly, the concept of centre of main interests¹⁶³ has been adopted to determine main and non main proceedings.¹⁶⁴ Thirdly, where an order recognizing a foreign proceeding is made, there is an obligation on the courts to cooperate to the maximum extent possible, with the foreign representative and the foreign court involved in the foreign proceeding.¹⁶⁵ Finally, the *CCAA* provisions expressly recognize multiple proceedings in order to facilitate coordination between local and one or more foreign proceedings and foster coordination of decision making.¹⁶⁶

However, the statutory *CCAA* cross-border provisions¹⁶⁷ wholly fail to address issues stemming from the financial distress of an enterprise group in the international context, despite the realities of enterprise group structures. Consequently, the use of substantive consolidation in the international context, the treatment of the assets and liabilities of two or more group members as if they were part of a single insolvency estate, remains a challenge to be met. It appears the current *CCAA* cross-border provisions only apply in terms of facilitating cooperation after substantive consolidation has been achieved in the domestic context.¹⁶⁸ However, even the current principle to cooperate appears problematic. Since the Canadian court may not be dealing

¹⁶² *CCAA* section 46.

¹⁶³ *CCAA* section 45(2). The centre of the debtor's main interest is defined as in the absence of proof to the contrary, a debtor company's registered office is deemed to be the centre of its main interests.

¹⁶⁴ *CCAA* section 45(1). A foreign main proceeding means a foreign proceeding in a jurisdiction where the debtor company has the centre of its main interests. A foreign non main proceedings means a foreign proceeding other than a foreign main proceeding.

¹⁶⁵ *CCAA* section 52(1).

¹⁶⁶ *CCAA* section 54 and 55. For a more detailed discussion on multiple proceedings see Sarra, J. P., "Crossing the Finish Line: the Potential Impact on Business Rescue of Adoption of new Cross-Border Insolvency Provisions." For full text see: <http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br02022.html>.

¹⁶⁷ The UNCITRAL Model Law on Cross-Border Insolvency Law also fails to recognise the existence of enterprise groups.

¹⁶⁸ UNCITRAL Working Group V, Report on Working Group V (Insolvency Law) on the work of its thirty-fifth session, Document A/CN.9/666, 17-21 November 2008, Vienna at paragraph 96.

with the same debtor as the foreign court each proceeding may appear unconnected to each other, making cooperation seem unnecessary.

The analysis of the existing jurisprudence in Chapter 3 also highlighted the Canadian courts have yet to examine the issues stemming from an order for substantive consolidation in the cross-border context. The focus of the judicial discourse has centred primarily on the circumstances Canadian courts should look towards when granting an order for substantive consolidation in the domestic context. The current framework is also strained by the nature of substantive consolidation and the various difficulties posed by a cross-border case.

6.3 Nature of Substantive Consolidation

An order for substantive consolidation is an uncommon occurrence due to its potentially dramatic impact on the rights of creditors. For this reason, the Canadian courts have restricted the use of substantive consolidation to a very limited set of circumstances and routinely expressed the benefits of such an order must outweigh the prejudice to particular creditors if the estates are consolidated. Therefore, substantive consolidation is an extraordinary remedy under the *CCAA*. It demands careful consideration to avoid any potential unfairness caused to one creditor group when forced to share *pari passu* with creditors from another entity that may be less solvent.¹⁶⁹ The practical effect on cross-border cases is that substantive consolidation is very narrow in application.

6.4 Difficulties Posed by Cross-Border Cases

In domestic *CCAA* proceedings where the debtor, creditors and all assets are within the territorial reach of the Canadian court, proceedings can be arguably straightforward and within the

¹⁶⁹ UNCITRAL Legislative Guide on Insolvency Law, Part Three; Treatment of Enterprise Groups in Insolvency, *supra*, footnote 1 at paragraph 108.

“comfort zone” of the court and parties privy to the proceedings. The mechanisms and remedies available to the debtor and its creditors under the CCAA are usually well understood.¹⁷⁰

However, if the debtor has assets or creditors in two or more jurisdictions, cross-border insolvency proceedings can become complex, generating various difficulties that may not occur in the domestic setting. These include; (a) differing approaches to insolvency, (b) differing approaches to cross-border insolvency and (c) language and information barriers.

6.4.1 Differing Approaches to Insolvency

The most noteworthy difficulty generated by a cross-border case is the differing attitudes to insolvency in various jurisdictions. Insolvency is commonly described as the inability of a debtor to command sufficient liquidity of resources to enable debts to be paid as they fall due.¹⁷¹

The phenomena of insolvency has to be dealt with by any society that recognises the use of credit because as soon as society provides the ability to commit to future performance of an obligation, it provides the chance that performance will not be possible at that future time.¹⁷²

Therefore, there is always a degree of risk that those who are owed money by a firm will suffer because the firm may be unable to meet its debts on the due date.¹⁷³ In today’s modern society, most jurisdictions possess a formal legal insolvency regime to tackle the inability of debtors to pay debts as they become due. However, the attitude and approach taken by the jurisdiction can and will vary the economic, legal and social consequences considerably.

¹⁷⁰ Town, L. J., “A Banker’s Perspective,” in Bridge M., and Stevens, R., *Cross-Border Security and Insolvency*, (Oxford: Oxford University Press, 2001).

¹⁷¹ Fletcher, I., *Insolvency in Private International Law*, (Oxford: Oxford University Press, 2005) at page 1. This is also known as the ‘cash-flow’ test of insolvency.

¹⁷² Tomlie, F. M., *Corporate and Personal Insolvency*, (Routledge: Cavendish, 2003) at page 3.

¹⁷³ Finch, V., *Corporate Insolvency Law: Themes and Perspectives*, (Cambridge: Cambridge University Press, 2002) at page 1.

These differences can be rooted principles of law, such as how to balance the interests of the debtor, its creditors and the wider society. The debtor corporation will usually attempt to restructure the business where possible to avoid liquidation, to continue operating and find a business strategy that enables it to meet the demands of creditors.¹⁷⁴ Creditors of the debtor corporation will want to recoup as much as possible of what they are owed and will be concerned about the division between themselves and the available assets.¹⁷⁵ Society as a whole demands the insolvency system provides a mechanism that does not favour the debtor to the extent that there is no incentive to meet its obligations but to ensure where possible the devastating economic and social consequences of the cessation of business operations are avoided.¹⁷⁶ Therefore, the approach taken by the jurisdiction in balancing the interests of the debtor, creditor and the wider society, will vary the availability of pro-debtor or pro-creditor mechanisms. For example, in the recent global restructuring of the Nortel group, the availability of helpful restructuring laws in any given jurisdiction was a significant factor taken into consideration by Canadian legal counsel when determining where to file for insolvency proceedings across the world.¹⁷⁷ However, the same considerations can impact vital creditor concerns, such as the rules on the priority of claims, the order creditors' claims are paid from the debtor estate. Differences can also be less obvious, such as questions of procedure or due process.

The practical effect on the doctrine of substantive consolidation is twofold. Firstly, the remedy may not be widely accepted in all jurisdictions. Secondly, even in jurisdictions where substantive consolidation is available under domestic law, agreement by all concerned that particular group

¹⁷⁴ Sarra, Rescue, *supra*, footnote 38 at page 9.

¹⁷⁵ See Tomlie, *supra*, footnote 172.

¹⁷⁶ Sarra, Rescue, *supra*, footnote 38 at page 9.

¹⁷⁷ Tay D. C., and Stam, J. L., "Challenges of Restructuring and Integrated International Business," in Sarra, J. P. ed., 2009, *Annual Review of Insolvency Law*, (Toronto: Carswell, 2009) at page 235.

members should be consolidated on a cross-border basis may be absent or in question regarding various issues. An illustration of three example jurisdictions highlights these points further.

In England and Wales, courts remain committed to the orthodox principle of separate legal entity theory. As a result, the remedy of substantive consolidation is unavailable in both domestic and cross-border proceedings. On the contrary, Chapter 4 of this thesis revealed that substantive consolidation is available in the United States in certain prescribed circumstances. Yet, these circumstances are different from those adopted by the Canadian courts for the purpose of the CCAA. Therefore, in order to consolidate the assets and liabilities of two or more group members from Canada and the United States on a cross border basis agreement from all creditors will be demanded. In practice, achieving an agreement may prove difficult to achieve, making the application of substantive consolidation in cross-border cases extremely restrictive.

6.4.2 Differing Attitudes to Cross-Border Cases

The legal issues that arise in a cross-border case not only relate to the specific concerns of insolvency law but also derive from the international dimension of the case.¹⁷⁸ However, the approaches to cross-border insolvency can vary drastically between the jurisdictions involved. As a result, the literature indicates there are two key rival principles that dominate the approach towards cross-border cases; territorialism and universalism.

6.4.2.1 Territorialism

The traditional principle of territorialism indicates the court in each jurisdiction where the debtor has assets is responsible for the distribution of those assets. This approach is also referred to as the “grab rule” – creditors being able to grab assets available in the local proceedings. The

¹⁷⁸ *Ibid.*, at page 8.

practical effect is parallel proceedings are usually initiated in each jurisdiction that the debtor corporation has assets or creditors.

Lo Pucki argues the application of territorialism to multinational cases present no serious problems,¹⁷⁹ and in fact can be seen to have advantages. Firstly, from the local creditors' perspective, there is a smaller pool of assets available that will be held only for their benefit. Secondly, from the perspective of all parties privy to the proceedings, the system appears clear and predictable. It is the location of the particular asset that determines the identity of the court and the law that will be applied, the *lex situs*. The third advantage is an offspring of the second. Clearly identified forums and laws enable parties to act quickly and courts to be prompt.

The practical effect on substantive consolidation is that territorialism appears to only permit the insolvency estates in the reach of the local court to be consolidated. This approach can lead to two unfavourable outcomes. Firstly, if substantive consolidation is applied separately in multiple proceedings, it may create an inefficient administration of the enterprise group. Litigation costs can increase whilst the process of obtaining a timely resolution may be slower. Secondly, the process may lower the overall value of the debtor's assets since the value of the whole debtor estate will always be greater than the sum of the constituent parts.¹⁸⁰ Therefore, the

¹⁷⁹ Lo Pucki, L., "The Case for Cooperative Territoriality in International Bankruptcy," (1999) 98 *Michigan Law Review*, 2216 at page 2219. Also see Lo Pucki, L., "Global and Out of Control," (2005) 79 *American Bankruptcy Law Journal*, 79; Lo Pucki, L., "Universalism Unravels," (2005) 79 *American Bankruptcy Law Journal*, 143.

¹⁸⁰ Justice Farley at the UNCITRAL 6th Multinational Judicial Colloquium, held in Sydney Australia 12-15th March 2005. For full text and comments made by Justice Farley see: <http://www.UNCITRAL.org/pdf/english/news/SixthJC.pdf>. Justice Farley was a former judge on the Ontario Superior Court, with extensive experience in corporate insolvency proceedings.

disadvantages with territorialism approach have led many jurisdictions to turn to the principle of universalism that takes a global view of the debtor's affairs.

6.4.2.1 Universalism

The principle of universalism requires all assets and claims to be resolved in one single proceeding, having “universal” effect over all property and interests of the debtor.¹⁸¹ The practical effect is there is a single forum that manages the case, collects the assets, regulates reorganisation and provides for the payment of creditors.¹⁸² “Pure” universalism requires the harmonisation of national legal systems resulting in a single global insolvency system. Therefore, the concept of universalism can only be described as an aspiration¹⁸³ and guiding principle rather than a working mechanism. However, it has led to the creation of “modified universalism.” The approach respects nation's domestic laws but provides for a single main proceeding in the debtor's home country but recognises the support of ancillary proceedings where assets are located or support from the local court is required.¹⁸⁴ Modified universalism is the foundation of the CCAA cross-border provisions. The practical effect of modified universalism on the remedy of substantive consolidation in the cross-border context is that it encourages courts to take a global view of the enterprise group.

¹⁸¹ See Fletcher, *supra*, footnote 171 at page 12.

¹⁸² Westbrook, J., “A Global Solution to International Default,” (1997) 98 *Michigan Law Review*, 2276 at pages 2292-97. For further commentary on the principle of universalism and modified universalism see: Westbrook, J., “Multinational Enterprises in General Default: Chapter 15, the ALI Principles, and the EU Insolvency Regulation,” (2002) 76 *American Bankruptcy Law Journal*, 1.

¹⁸³ *Cambridge Gas Transport Corporation v. Official Committee of Unsecured Creditors (of Navigator Holdings Plc and others)*, [2006] U.K.P.C. 26 (Privy Council) *per* Lord Hoffman at paragraph 17.

¹⁸⁴ See Westbrook, *supra*, footnote 182 at 2300.

6.4.3 Language and Information Barriers

Language barriers can pose an additional layer of practical complexity and inconvenience in cross-border proceedings. For example, despite Canada, the United Kingdom and the United States share a common language, the legal terminology can be poles apart.

Imperfect or lack of information can also hinder the ability of parties privy to the proceedings to make fully informed decisions. For example, in the Nortel restructuring information concerning the financial position of each individual corporation and the debt structure of the global enterprise was hard to obtain.¹⁸⁵ Similar experiences can be seen in the Maxwell Communications Corporation restructuring in 1991. The group's principal assets were situated in the United States. Yet the collapse of the corporation highlighted the group kept its corporate books in pounds sterling and owed most of its USD \$2.4 billion debt to British Banks and London branches of foreign banks.¹⁸⁶ Therefore, it may be difficult for parties to agree the insolvency estates should be consolidated in the presence of asymmetric information.

6.5 Summary

The current landscape indicates the remedy of substantive consolidation is not a common occurrence in cross-border cases. The CCAA cross-border provisions fail to recognize the existence of enterprise groups, in turn further restricting the use of the doctrine. The difficulties encountered in cross-border cases also make its application problematic and unpredictable.

¹⁸⁵ See Tay and Stam, *supra*, footnote 177 at page 234.

¹⁸⁶ Mason, R., "Cross-border Insolvency Law: Where Private International Law and Insolvency Law Meet," in Omar, P., *International Insolvency Law: Themes and Perspectives*, (Ashgate Publishing, 2008) at page 36. For further commentary on the Maxwell Communications Corporation restructuring see: Clarke, T., "Case Study: Robert Maxwell, Master of Corporate Misfeasance," (1993) 1(3) *Corporate Governance*, 141.

Nonetheless, given the general recognition that the number of cross-border cases is increasing around the world¹⁸⁷ and the reality of enterprise group structures, it is argued there is significant value in exploring mechanisms that facilitate the use of substantive consolidation in the international context. Therefore, the following section explores the dominant principles of Canadian cross-border insolvency law and the Working Group V literature in order to determine how the current position could be enhanced.

6.6 Dominant Principles of Canadian Cross-Border Insolvency Law

6.6.1 Introduction

The common difficulties posed by a cross-border case highlighted *CCAA* cross-border cases have a multidimensional scope. There is a need to respond to both the insolvency of the debtor and the international features of the case. In response, Canadian cross-border draws upon a blend of principles. This section identifies four key principles: (a) collectivity, (b) modified universalism, (c) comity and (d) cooperation.

6.6.2 Collectivity

If a number of creditors were owed money and all pursued the rights and remedies available to them, a chaotic race to protect interests would take place that might lead to inefficiencies and unfairness.¹⁸⁸ Consequently, the fundamental assumption underlying insolvency law is the interests of individual creditors, and in particular their rights to collect in the debts due to them by one or other methods of enforcing payments of judgement debts, must give way to the

¹⁸⁷ UNCITRAL/INSOL/World Bank 8th Multinational Judicial Colloquium on Insolvency Report, 20-21 June 2009, Vancouver. See <http://www.UNCITRAL.org/pdf/english/news/EighthJC.pdf> at paragraph 8.

¹⁸⁸ *Ibid.*, at page 5. This may result in unfairness due to first come first served, and costs relating to every individual action brought against the debtor leading to decreased value in the debtor estate for the benefit of all creditors.

collective interest of the general body of creditors.¹⁸⁹ Therefore, the *CCAA* provides a collective debt collection device in response to the “common pool problem” where creditors assert rights over a limited common pool of assets.¹⁹⁰ The practical effect of the principle of collectivity is two-fold. Firstly, the multiple individual relationships between the debtor and its creditors are combined. Secondly, in order to address the question of how the incidence of loss from the limited common pool of assets will be borne by its creditors, pre-insolvency rights that were established are replaced by a system of priority of claims. The *BIA* stipulates the priority of claims, the ranking of creditors’ claims, for the purposes of the *CCAA* in the following order; priority charges,¹⁹¹ secured creditors claims,¹⁹² preferred creditors,¹⁹³ ordinary unsecured creditors¹⁹⁴ and deferred creditors.¹⁹⁵

6.6.3 Modified Universalism

Traditionally, Canada took a territorial approach to cross-border cases. Local assets would be seized and distributed to the creditors in the local proceeding with little concern for the overall result for the corporation or foreign creditors outside the domestic jurisdiction. However, the growth of the global market place has demanded mechanisms that facilitate the reorganisation of

¹⁸⁹ Goode, R., *Principles of Corporate Insolvency Law*, (London: Thomson, 2005) at page 61.

¹⁹⁰ Jackson, T. H., *Logic and Limits of Bankruptcy Law*, (Beard Books, 2001) see chapters 1-2.

¹⁹¹ *BIA* section 136(1) provides an employee of an employer which is bankrupt or in receivership, with a priority charge on the employer’s “current assets” for unpaid wages and vacation pay (but not for severance or termination pay). This charge will secure unpaid wages and vacation pay for the six month period prior to bankruptcy or receivership to a maximum of \$2,000 per employee (plus up to \$1,000 for expenses for “traveling salespersons”). The priority charge ranks ahead of all other claims, including secured claims, except unpaid supplier rights. Section 136 (1) *BIA* now also grants a priority charge in bankruptcies and receiverships for outstanding current service pension plan contributions, ranking behind the wage earners priority but otherwise with the same priority as is accorded to that lien. The pension contribution priority extends to all assets, not just current assets, and is unlimited in amount.

¹⁹² *BIA* section 136(1) *BIA*.

¹⁹³ *Ibid.*

¹⁹⁴ *BIA* section 141.

¹⁹⁵ *BIA* section 137-140.

a debtor with assets or creditors in two or more jurisdictions. The practical effect on Canadian cross-border insolvency law is that there has been a shift towards modified universalism as a dominant principle. This shift is reflected by the enactment of the *CCAA* cross-border provisions.

6.6.4 Comity and Cooperation

The principle of comity and cooperation are dominant features of Canadian cross-border insolvency law. This view was also reflected in *Roberts v. Picture Butte Municipal Hospital* whereby Justice Forsyth stated:

“comity and co-operation are increasingly important in the bankruptcy context...without some coordination, there would be multiple proceedings, inconsistent judgements and general uncertainty.”¹⁹⁶

The principle of comity was defined by Justice La Forest in the Supreme Court of Canada decision of *Morguard Investments v. De Savoye* as:

“deference and respect due by other states to the actions of a state legitimately taken within its territory,¹⁹⁷...to facilitate the flow of wealth, skills and people across state lines in a fair and orderly manner.”¹⁹⁸

¹⁹⁶ *Roberts v. Picture Butte Municipal Hospital*, (1998) [1999] 4 W.W.R. 443, 64 Alta L.R. (3d) 218, [1998] A.J. No. 817 (Alta. Q.B.), at paragraph 5.

¹⁹⁷ *Morguard Investments Ltd. v. De Savoye*, [1990] 3 S.C.R. 1077 (S.C.C.). For further discussion on the nature of the principle of comity see: Paul, J. R., “Comity in International Law,” (1991) 32 *Harvard International Law Journal*, 1; Yntema, E., “The Comity Doctrine,” (1996) 65 *Michigan Law Review*, 1; Webb, P. R. H., “Comity and Reciprocity,” (1966) 15 *International and Comparative Law Quarterly*, 269.

¹⁹⁸ *Ibid.*, per Justice La Forest at paragraph 1096.

Since then, Canada has demonstrated itself to be a jurisdiction clearly committed to the principle of comity having both the legislative support and case law precedent to do so.¹⁹⁹ Jurisprudence highlights the courts continue to rely upon the principle of comity to recognize and enforce the judicial acts of other jurisdictions. In *Re Babcock and Wilson Canada Ltd* Justice Farley reiterated “there is a necessity and desirability, in a mobile global society, for governments and courts to respect the orders made by courts in foreign jurisdictions.”²⁰⁰ In *Re Lear Canada*, Justice Pepall also noted:

“courts have recognized that in the context of cross-border insolvencies comity is to be encouraged. Efforts are made to complement, coordinate, and where appropriate, accommodate insolvency proceedings commenced in foreign jurisdictions.”²⁰¹

Canadian courts have also drawn on the principle of comity to suggest that multiplicity of proceedings should be prevented. In *Re Matlack* Justice Farley noted:

“where a cross-border insolvency proceeding is most closely connected to one jurisdiction, it is appropriate for the court in that jurisdiction to exercise principal control over the insolvency process in light of the principle of comity.”²⁰²

¹⁹⁹ Weisz, S., and Park, K., “Comity, Co-operation and Sovereignty – A Distinctly Canadian Approach.” For full text see: <http://www.blakes.com/english/view.asp?ID=329>.

²⁰⁰ *Re Babcock and Wilson Canada Limited*, 2000 CarswellOnt 704, 5 B.L.R. (3d) 75, 18 C.B.R. (4th) 157 (O.S.C.J.), at paragraph 6.

²⁰¹ *Re Lear Canada*, 2009 CarswellOnt 4232, 55 C.B.R. (5th) 57 (O.S.C.J.), at paragraph 11.

²⁰² *Re Matlack Inc.*, 2001 CarswellOnt 1830, 26 C.B.R. (4th) 45, [2001] O.T.C 382 (O.S.C.J.), at paragraph 8.

The principle of cooperation is enshrined in the CCAA statutory framework. As already noted in this Chapter, there is an obligation on the courts to cooperate to the maximum extent possible, with the foreign representative and the foreign court involved in the foreign proceeding.²⁰³

6.7 Working Group V Findings: Extending Cooperation to Apply to Enterprise Groups

The Working Group V literature recognises that consolidation in cross border cases is not common. However, examples of cases where the insolvency of a closely integrated group involving subsidiaries in different jurisdictions has been administered as if it were a single entity with the consent of creditors, as well as examples involving a unified reorganization plan were acknowledged.²⁰⁴ Nevertheless, while benefits can arise from consolidating insolvency estates in the cross-border context, the international dimension adds further complexity.²⁰⁵ Further, Working Group V has noted the scope of the Model Law did not apply to enterprise groups and currently had limited application. Hence, the Model Law might only apply to substantive consolidation in terms of facilitating cooperation after consolidation has been achieved in a domestic context.²⁰⁶

In the recently published *Legislative Guide on Insolvency Law, Part Three: The Treatment of Enterprise Groups*, Working Group V proposes the first step in finding a solution to the problem of how to facilitate the global treatment of enterprise groups will be to ensure that existing principles for cross-border cooperation apply to enterprise groups.²⁰⁷ Accordingly, various draft legislative recommendations have been proposed in order to promote cooperation in enterprise

²⁰³ CCAA section 52(1).

²⁰⁴ UNCITRAL Working Group V, Note by Secretariat, Document A/CN.9/WG.V/WP.76/Add.2, 14-18 May 2007, New York at paragraph 27.

²⁰⁵ UNCITRAL Working Group V, *supra*, footnote 5 at paragraph 61.

²⁰⁶ UNCITRAL Working Group V, *supra*, footnote 168 at paragraph 96.

²⁰⁷ UNCITRAL Legislative Guide on Insolvency Law, Part Three; Treatment of Enterprise Groups in Insolvency, *supra*, footnote 1 at paragraph 7. .

group situations. These include: (a) ensuring foreign representatives and creditors have access to the courts for foreign representatives and the recognition of the foreign proceedings in respect to enterprise groups;²⁰⁸ (b) cooperation between the domestic court and foreign courts or foreign representatives;²⁰⁹ (c) cooperation to the maximum extent possible between courts;²¹⁰ (d) the use of direct communication between the domestic court and foreign courts or foreign representatives;²¹¹ (e) cooperation between the insolvency representative and foreign courts;²¹² (f) cooperation between the insolvency representative;²¹³ (g) communication between insolvency

²⁰⁸ *Ibid.*, at paragraph 19. The recommended legislative provisions state the insolvency law should provide, in the context of insolvency proceedings with respect to enterprise group members, (a) access to the courts for foreign representatives and creditors; and (b) recognition of the foreign proceedings, if necessary under applicable law.

²⁰⁹ *Ibid.*, at paragraph 40. The recommended legislative provisions state The insolvency law should permit the court that is competent with respect to insolvency proceedings concerning an enterprise group member to cooperate to the maximum extent possible with foreign courts or foreign representatives, either directly or through the insolvency representative or other person appointed to act at the direction of the court, to facilitate coordination of those proceedings and insolvency proceedings commenced in other States with respect to members of the same enterprise group.

²¹⁰ *Ibid.*, at paragraph 40. The recommended legislative provisions state the insolvency law should specify that cooperation to the maximum extent possible between the court and foreign courts or foreign representatives be implemented by any appropriate means.

²¹¹ *Ibid.*, at paragraph 40. The recommended legislative provisions state the insolvency law should permit the court that is competent with respect to insolvency proceedings concerning an enterprise group member to communicate directly with, or to request information or assistance directly from, foreign courts or foreign representatives concerning those proceedings and insolvency proceedings commenced in other States with respect to members of the same enterprise group to facilitate coordination of those proceedings.

²¹² *Ibid.*, at paragraph 42. The recommended legislative provisions state the insolvency law should permit the insolvency representative appointed to administer insolvency proceedings with respect to an enterprise group member, in the exercise of its functions and subject to the supervision of the court, to cooperate to the maximum extent possible with foreign courts to facilitate coordination of those proceedings and insolvency proceedings commenced in other States with respect to members of the same enterprise group.

²¹³ *Ibid.*, at paragraph 42. The recommended legislative provisions state the insolvency law should permit the insolvency representative appointed to administer insolvency proceedings with respect to an enterprise group member, in the exercise of its functions and subject to the supervision of the court, to cooperate to the maximum extent possible with foreign representatives⁶⁷ appointed to administer insolvency proceedings commenced in other States with respect to members of the same enterprise group in order to facilitate coordination of those proceedings.

representatives and communication between the insolvency representatives and the foreign courts;²¹⁴ (h) and the appointment of a single or the same insolvency representative.²¹⁵

6.8 Cross-Border Protocols to Further Facilitate Cooperation

Sarra notes that cross-border protocols have been approved by Canadian courts as a mechanism to facilitate cross-border proceedings involving multiple related corporate entities. The cross-border protocol creates a legal framework for the conduct of insolvency proceedings and coordination of administration of an insolvent estate in one state with the administration in another.²¹⁶ For example, a cross-border protocol was used in the recent *CCAA* case of *Re AbitibiBowater Inc.* between the Superior Court of the Province of Québec and United States Bankruptcy Court for the District of Delaware.²¹⁷

Working Group V has also recognised the benefits of using cross-border protocols. Cross-border protocols can effectively reduce the cost of litigation and enable parties to focus on the conduct of the insolvency proceedings rather than resolving conflict of laws and other such disputes.

²¹⁴ *Ibid.*, at paragraph 42.

²¹⁵ *Ibid.*, at paragraph 47. The recommended legislative provisions state The insolvency law should permit the court, in appropriate cases, to coordinate with foreign courts with respect to the appointment of a single or the same insolvency representative to administer insolvency proceedings concerning members of the same enterprise group in different States, provided that the insolvency representative is qualified to be appointed in each of the relevant States. To the extent required by applicable law, the insolvency representative would be subject to the supervision of each of the appointing courts.

²¹⁶ Sarra, *Crossing the Finishing Line*, *supra*, footnote 166.

²¹⁷ *Re AbitibiBowater Inc.*, 2010 CarswellQue 2338 (Quebec Superior Court). The disclosure statement for debtors second amended joint plan of reorganisation under Chapter 11 of the Bankruptcy Code notes the cross-border protocol intends to: facilitate cross-border coordination between the Chapter 11 cases and *CCAA* Proceedings. The cross-border protocol provides that its purpose is to effectuate an orderly and efficient administration of the Chapter 11 Cases and *CCAA* Proceedings, and to maintain the respective independent jurisdiction of the Canadian court and the Bankruptcy Court.

The Canadian court shall have sole and exclusive jurisdiction over the *CCAA* proceedings, and the Bankruptcy Court shall have sole and exclusive jurisdiction over the Chapter 11 cases. The Bankruptcy Court and the Canadian Court may coordinate activities, communicate with one another and conduct joint hearings. See: <http://www.abitibibowatercommittee.info/Dkt%202797%20Disclosure%20Statement.pdf>

Moreover, in addition to clarifying parties' expectations, these protocols can help preserve the debtor's assets and maximize their value.²¹⁸ Therefore, Working Group V argues it would be desirable that protocols continue to be used in the group context. It enables parties to conclude agreements concerning different group members in different states and permit courts to approve them and implement them, taking into account the group context.²¹⁹

6.9 Lessons for the CCAA

In recent years, the Canadian courts have shown a great willingness to take a global view of a debtor's financial distress by providing recognition to foreign proceedings and cooperation with foreign courts and insolvency representatives in order to facilitate successful restructurings. The various benefits derived from cross-border protocols have also been endorsed by the Canadian courts.²²⁰ However, since the current CCAA cross-border provisions fail to recognise the existence of enterprise groups the courts still face practical difficulties in determining how to restructure the affairs of the enterprise group. Cooperation by the courts may appear unwarranted if the courts are dealing with different debtors within an enterprise group.

Therefore, the CCAA framework would profit from adopting the legislative recommendations of Working Group V that promote cooperation in the context of enterprise groups. By doing so, it opens the door for courts to recognise substantive consolidation orders from foreign courts relating to debtors of the enterprise group. Nevertheless, the practical the use of substantive

²¹⁸ UNCITRAL Legislative Guide on Insolvency Law, Part Three; Treatment of Enterprise Groups in Insolvency, *supra*, footnote 1 at paragraph 48.

²¹⁹ *Ibid.*, at paragraph 53.

²²⁰ American Law Institute, *Guidelines Applicable to Court-to-Court Communications in Cross-Border Cases*, 2001. The Guidelines were developed by ALI during and as part of its Transnational Insolvency Project and are directed at facilitating communication between courts in multijurisdictional proceedings. For full text see: <http://www.ali.org/doc/Guidelines.pdf>.

²²⁰ CCAA section 52(1) and BIA section 275(1).

consolidation in *CCAA* cross-border proceedings raises the question whether there should be creditors' committees that represent all creditors from the consolidated enterprise group members. Sarra notes the use of substantive consolidation in the cross-border context could create barriers to the participation of unsecured creditors where they are located in jurisdictions other than that of the main proceeding.²²¹ In particular, Sarra argues it may affect the ability of employees and pensioners to participate in workout proceedings where the enterprise group proceeding is not in their domestic jurisdiction.²²² However, whilst the Canadian courts will have to continue to ensure the substantive rights of creditors in Canada are protected, it is argued that the recognition of the enterprise group for the purposes of cooperation and continued use of cross-border protocols will foster greater participation of unsecured creditors.

6.10 Conclusion

To this end, linked to many issues relating to enterprise groups in the cross-border context, it appears the remedy of substantive consolidation continues to be problematic. The current landscape fails to recognise the existence of the enterprise group structure and does not facilitate its use on the international stage. The Working Group V literature promotes the principle of cooperation as a method to overcome the existing difficulties encountered with the enterprise group. For the use of substantive consolidation under the *CCAA* framework, it is argued doing so would benefit the current position. It is both highly impractical and improbable to attempt to unify the approach to substantive consolidation in all jurisdictions, for there will certainly not be pure universalism. Therefore the principle of cooperation acts as a bridge between various

²²¹ Sarra, *Crossing the Finishing Line*, *supra*, footnote 166.

²²² *Ibid.*

approaches and attitudes that can facilitate effective restructuring and maximisation of value of the debtors' estate *en bloc*.

Chapter 7: Conclusion

This thesis was an in-depth study of the remedy of substantive consolidation under Canada's primary restructuring statute, the *CCAA*. By carefully examining how the remedy has evolved under the *CCAA*, the thesis has critiqued the current legal landscape for failing to provide an appropriate framework for addressing various issues stemming from an order of substantive consolidation. In response to this perceived lack of guidance from the Canadian courts and statutory authority, the thesis looked towards the discussions of UNCITRAL Working Group V and the United States jurisprudence in order to suggest an array of policy options for the use of the remedy under the *CCAA*.

The thesis indicated Canadian courts have pointed towards three circumstances that support consolidation in the domestic context. Firstly, consolidation must be appropriate in the circumstances. The court must determine whether the elements of consolidation are present, such as the significant intertwining of assets and liabilities. Secondly, there must be a balancing of interests, ensuring the benefits will outweigh the prejudice to particular creditors if the debtor estates are consolidated. Thirdly, it is appropriate to look at the overall effect of consolidation. However, this thesis argued there needs to be a suitable standard for determining whether there has been an intertwining of assets and liabilities. After considering the various standards proposed by UNCITRAL Working Group V, the thesis suggested the "without disproportionate expense or delay" approach is most suited to the *CCAA* framework. The thesis also suggested the *CCAA* framework could benefit from adopting the alternative circumstance of "debtors disregarding their separateness to such an extent that creditors viewed them as one entity" as adopted in the United States and considered by UNCITRAL Working Group V. Nevertheless the approach demands careful consideration of both the test used to determine whether the debtors

have disregarded their separateness and whether the circumstance should be limited to contractual claims.

This thesis argued the issues stemming from an application for substantive consolidation in the domestic context failed to be clearly addressed by the current legal landscape. The thesis first examined the idea that parties should be able to bring an application to the court. It argued that whilst the current approach permits both the debtor and creditor is satisfactory, monitors should also be able to bring an application before the court. The monitor usually possesses the most information regarding the financial affairs of the debtors. Further, any potential conflicts that arise from the extension in the monitor's role are limited by the discretion of the court.

To the contrary, the thesis argued Canadian courts should not be able to grant an order for substantive consolidation on its own initiative. Given the potentially drastic effect substantive consolidation can have on creditors' rights, there needs to be a fair and equitable process where all parties can be heard.

This thesis noted it is unclear from the existing case law whether notice is a prerequisite to an application for substantive consolidation, particularly when the application is brought at the same time as an *ex parte* application for an initial stay of proceedings. However, this thesis argued the potentially dramatic effect substantive consolidation has on creditor rights demands that notice of an application is provided to the creditors. Yet it appears notice to creditors of solvent group members would not be necessary since the *CCAA* framework only applies to insolvent debtors. Hence, the thesis also argued the remedy should not be available to solvent group members.

The thesis argued the current flexible approach to the timing of an application continues to be the most appropriate. The approach recognises that in some *CCAA* cases the factors supporting consolidation may not be certain or apparent at the time insolvency proceedings commence. As a result the remedy will be available in a wide number of restructuring scenarios.

The thesis noted cross-border substantive consolidation under the *CCAA* is not a common occurrence due to the difficulties generated in the international sphere. There are varying approaches to substantive consolidation and cross-border restructuring. Further, from the perspective of the *CCAA*, the existing provisions fail to address the notion of an enterprise group. As a result, it appears the obligation on Canadian courts to cooperate to the maximum extent possible with a foreign court that has granted an order for substantive consolidation has limited application. The court may be dealing with a different debtor than the foreign court, making cooperation seem unnecessary. Informed by the discussions of UNCITRAL Working Group V, this thesis strongly argued that promoting the use of cooperation in the context of enterprise groups could facilitate the use of substantive consolidation more frequently in the cross-border context. Further the thesis suggests the continued use of cross-border protocols in *CCAA* cross-border restructurings will assist in resolving the substantive and procedural issues stemming from an order of substantive consolidation.

To this end, a closer examination of the remedy of substantive consolidation under the *CCAA* framework reveals the need to consider various issues that stem from such an order in both the domestic and cross-border context. This paper has attempted to tackle each in turn, taking into account the scope of the *CCAA*, the balance between the need for flexibility and the demand for certainty in *CCAA* proceedings, what is desirable in practice and the nature of cross-border

restructuring proceedings. It is hoped legislators and future courts will recognise the need to address these issues in order to enhance the somewhat unfavourable position of the current law.

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