THE REORGANIZATION OF INSOLVENT BUSINESSES:
A FUNCTIONAL COMPARISON OF THE CANADIAN AND AMERICAN MODELS

by

KEITH DENNIS YAMAUCHI
B.A., The University of Calgary, 1977
LL.B., The University of Saskatchewan, 1981

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Department of Law

The University of British Columbia
Vancouver, Canada

Date 14 September 1994
ABSTRACT

The business reorganization systems available to financially-distressed businesses in Canada are evolving into a system similar to that employed in the United States under Bankruptcy Reform Act of 1978 (Code). Business reorganizations have been an integral part of American commercial culture for almost a century. In Canada, business debtors may resort to the Companies' Creditors Arrangement Act (CCAA) or the Bankruptcy and Insolvency Act (BIA), when seeking to reorganize their affairs. However, Canadian debtors use those systems sparingly.

A primary objective of a business reorganization system is to balance the debtor's rehabilitation efforts with the rights of creditors. This paper examines the Code and conducts a functional comparative analysis of certain aspects of the Canadian and American systems. The purpose of this examination is to determine whether the systems accomplish that objective and whether the Canadian systems could accomplish that objective more effectively by examining and incorporating aspects of other systems.

This paper argues that the BIA neither encourages the debtor's rehabilitation efforts nor treats creditors equitably. The primary reason for this shortcoming was the failure of the policymakers to consider the objectives of a business reorganization system. These policy objectives formed the foundation of the Code. As a result, the Code contains concepts that attempt to balance the interests of debtors and creditors and gives the courts the necessary flexibility to mould the concepts to achieve that balance. The CCAA provides little procedural or substantive guidance concerning its policy objectives. Accordingly, the courts have significant flexibility in applying its provisions. However, that flexibility also results in a lack predictability.

The proposal provisions of the BIA must undergo significant changes before it becomes a workable business reorganization model. Further efforts at bankruptcy reform must include a thorough study of legislative and doctrinal aspects of systems other than those used domestically. This paper
argues that Canadian policymakers could create a fair and equitable business reorganization system by using the concepts in the Code and those developed under the CCAA and by attempting to resolve shortcomings of those systems identified by the courts and commentators.
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GLOSSARY


Chapter 11: Code, ss. 1101-1174.

Chapter X: Chandler Act, ss. 101-276.

Chapter XI: Chandler Act, ss. 301-399.


former Canadian Act: Bankruptcy Act, R.S.C. 1985, c. B-3, as am. up to but not including S.C. 1992, c. 27.


CHAPTER I
INTRODUCTION

A. CONCEPTUAL FRAMEWORK AND ISSUES

In 1947, in the seminal article on the CCAA, Stanley E. Edwards wrote the following, when speaking about the development of business reorganization law in Canada:

Canadians are fortunately in a position to adopt the portions they choose from the solutions, both statutory and judicial, which have been worked out in the United States and Great Britain. The wisdom of the procedures and rules worked out there will be examined in the light of Canadian conditions in an effort to devise the fairest and most feasible scheme possible for application of the C.C.A.A.¹

From the time of Edwards' article to the early 1980s, there were few business reorganizations in Canada. There were two reasons for this. First, there was the notion that the CCAA was intended for large companies with complex capital structures.² Few companies met these criteria. The second reason was that the former Canadian Act did not allow the debtor to bind secured creditors to the proposal provisions or the ancillary provisions of the act that were enacted to facilitate proposals.

Debtors started using the CCAA in the early 1980s and since then, it has become the "remedy of choice"³ of debtors seeking to reorganize their financial affairs. However, the structure of the CCAA requires the debtor to make numerous court applications to accomplish the objectives of the act. Thus, companies that use the CCAA must have the necessary financial backing to withstand the significant costs attendant on such a proceeding. The former Canadian Act continued to be of little use to debtors with significant secured debt.

Bill C-22,⁴ which received Royal Assent on June 23, 1992, resulted in significant amendments

² For a discussion of this issue, see chapter III(B), below.
to the former Canadian Act. The amendments changed the name of the former Canadian Act to the
Bankruptcy and Insolvency Act\(^5\) and they were proclaimed in force on November 30, 1992.\(^6\) The BIA
completely changed substantive and procedural aspects of the proposal provisions of the former
Canadian Act. The most significant change was to the rights and duties of secured creditors. The
debtor now has the ability to stay proceedings of secured creditors and to bind a minority of secured
creditors should a majority accept the proposal. The BIA did not repeal the CCAA and, as a result,
debtors in Canada presently have a choice of reorganization regimes under which to proceed.

By its terms, the provisions and the operation of the BIA are to be reviewed by a
parliamentary committee established for that purpose.\(^7\) Parliament has formed the committee and its
purpose is to:

... provide a forum to discuss and determine priorities for insolvency reform for the next
several years and to allow for the development of a consensus on policy recommendations in
various areas of concern.\(^8\)

The parliamentary committee has established a number of working groups. The object of each
working group is to focus on a specific area of concern.\(^9\) Working Group #2 is to focus on, *inter alia*,
commercial reorganization issues. The Superintendent of Bankruptcy views the provision requiring the

\(5\) S.C. 1992, c. 27, s. 2.

\(6\) P.C. 1992-2180, SI/92-194, C. Gaz. 1992.II.4079. Certain administrative provisions were
provisions will not be addressed in this paper.

\(7\) S.C. 1992, c. 27, s. 92 provides:

"After the expiration of three years after this section comes into force, this Act shall stand
referred to such committee of the House of Commons, of the Senate or of both Houses of
Parliament as may be designated or established for that purpose and the committee shall, as
soon as practicable thereafter, undertake a comprehensive review of the provisions and
operation of this Act and shall, within one year after the review is undertaken or within such
further time as the House of Commons authorize, submit a report to Parliament thereon."

\(8\) S.J. Kershman, "Working Groups of the Bankruptcy and Insolvency Committee" (1993) 13:3

review by the parliamentary committee as continuing the momentum started by the enactment of the amendments. He goes on to state:

The opportunity presented by that review will only be meaningful if interested parties keep the process alive by making the Government aware of the need for ongoing reform. The [parliamentary committee] provides a unique forum through which to set the agenda for research and reform and to shape the future direction of the insolvency process.

This paper is intended to contribute to that discourse.

During that review, the parliamentary committee must examine whether the amendments meet the broader objectives of a business reorganization regime. This paper will show that the committee cannot undertake this task without taking advantage of the methodology suggested by Stanley E. Edwards, over four decades ago.

In considering the CCAA, a number of courts and writers use American case law in their arguments and discussion and they have alluded to the fact that the CCAA is evolving in a way that provides the parties to the proceeding with rights similar to those contained expressly in the Code. The few cases that have considered the BIA appear to be taking an approach similar to that taken under the CCAA.

The Colter Committee Report specifically rejected the wholesale adoption of the reorganization provisions contained in Chapter 11 and the administrative provisions contained in chapter 3 of the Code. Parliament appeared to have taken this advice, although there may be sufficient flexibility in the BIA to allow some of the Code's more desirable concepts to be used in a Canadian business


11 Ibid.


13 Colter Committee Report at 53-54.
reorganization. It is not clear why the Colter Committee Report and Parliament were determined to reject all aspects of the American model. There are aspects of the American model that are less than desirable, such as the time necessary to complete most proceedings under Chapter 11 and the fact that few debtors emerge from the proceedings as viable entities. However, this should not have discouraged Parliament from incorporating some of the Code's more equitable provisions and the notions developed by the American courts that balance the interests of debtors and their creditors. Parliament should not have rejected the American model without a thorough examination of the and the practical effects flowing from it.

This paper will illustrate the utility of conducting such an examination, to show that certain concepts developed in the United States could more effectively deal with Canadian business reorganizations. While it is acknowledged that Parliament incorporated certain mechanisms similar to those used in the Code, considerable litigation will be necessary to resolve the uncertainties created by such piecemeal incorporation. This shortcoming could have been avoided in the original drafting of the BIA.

A further concern is the suggestion that Parliament will repeal the CCAA sometime following the presentation of the parliamentary committee report. The CCAA is a flexible reorganization tool that the courts have generally adapted to fit the circumstances of the particular case. Should Parliament repeal the CCAA, without incorporating some of the principles developed under it into the BIA, a debtor seeking relief must reestablish those principles to obtain equivalent relief. This is not an efficient way of proceeding, given that the CCAA and the American statutory and judicial solutions are at the disposal of the policymakers.


Supra note 7.
With respect, the BIA is not a useful reorganization tool. A reason for this shortcoming is that the legislators failed to determine the "spirit and intent" of the legislation and, in particular, they failed to consider the broader objectives of the legislation or how the legislation would actually work in practice. A primary objective of a business reorganization statute is to provide the debtor with a structure within which to rehabilitate, while ensuring the equitable treatment of creditors. This paper will examine whether the structure of the proposal provisions of the BIA serves to accomplish that objective or whether the American model or the model established under the CCAA is more conducive to accomplishing that objective.

In exploring these issues, this paper will pay special attention to the rights and duties of secured creditors. In the United States, the Code tends to restrict the rights of secured creditors in to facilitate the object of achieving equity and fairness in the distribution of the assets comprising the estate and affording the debtor a fresh start. However, in restricting those rights, the Code attempts to preserve the relative positions of secured creditors by providing certain protective measures.

The former Canadian Act placed few restrictions on the rights of secured creditors. The Tassé Report suggested that, when Parliament passed the first Canadian bankruptcy statute, secured creditors held such a small proportion of the total debt that giving them special treatment was not justified. That report and the Colter Committee Report suggested that any bankruptcy reform should include provisions for at least monitoring and perhaps placing restrictions on the rights of secured creditors. The BIA includes certain restrictions on the rights of secured creditors and places certain duties on them. One of the purposes of this paper is to explore whether the amendments are conceptually effective to alleviate the inefficiencies and inadequacies perceived by the Tassé Report and the Colter

18 F.R Kennedy, "Secured Creditors Under the Bankruptcy Reform Act" (1982) 15 Ind. L. Rev. 477 at 482.
19 Tassé Report at 56.
20 Colter Committee Report at 56-58; Tassé Report at 96-98.
Committee Report.

B. LITERATURE REVIEW

Most of the articles and treatises written on business reorganizations have dealt with issues arising out of domestic legislation, with very little attention being paid to the legislation or case law of other jurisdictions. Several excellent articles have been written that describe and synthesize the case law decided under the CCAA\(^{21}\) and there are numerous American textbooks and services that describe in detail the policies and procedures involved in a Chapter 11 proceeding.\(^ {22}\) The reader may obtain background information from those works, as it is not the intent of this paper to describe the procedures and case law, other than to assist in resolving the issues at hand.

The BIA has received little scholarly attention to date. Most of the articles have been prepared for continuing legal education panels that, for the most part, describe the amendments, with possible ramifications.\(^ {23}\)

Three articles have taken a more general approach to the policy issues arising out of a business reorganization system by looking to Canadian and American legislation and case law. Edwards\(^ {24}\) article is important and frequently-cited, as it sets forth the policy objectives of a business

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\(^{22}\) See e.g., Norton Bankruptcy Law & Practice, vol. 4; M.J. Bienenstock, *Bankruptcy Reorganization* (New York: Practicing Law Institute, 1987).

\(^{23}\) One exception is R.A. Klotz, "Protection of Unpaid Suppliers Under the New Bankruptcy and Insolvency Act" (1993) 21 Can. Bus. L.J. 161, where the author undertakes an examination and a comparative analysis of the right of repossession under the BIA and refers to similar rights under the Quebec Civil Code, the American Uniform Commercial Code and the Code. This issue will not be examined in this paper. See also Honsberger, *supra* note 21.

reorganization system. While recognizing the "great potential importance" of the CCAA, Edwards expressed the limitation of his work by stating that the CCAA "has received little attention in either Canadian legal literature or the decisions of the courts." He proposed a methodology for the study of Canadian reorganization law by recommending that the student consider the reorganization laws of other countries. Edwards abides by that advice and illustrates his points by reference to American and English cases. In reviewing his article, one must remember that he was considering a previous version of the American reorganization regime and therefore, its present use for interpreting particular provisions may be limited. However, the valuable insight that Edwards provided into the policy of business reorganization systems is as valid today as in 1947 and therefore, this paper will refer to his work, from time to time.

An article by Professor George Triantis examined the effectiveness of the draft BIA in quelling the desire of creditors in a reorganization proceeding to hold out for a greater proportion of the "going concern surplus." Professor Triantis sees the objective of bankruptcy reorganization law as a solution to this "collective action problem" which results in the liquidation of a debtor that is worth more as a going concern than the aggregate liquidation value of its assets. He discusses the stay of proceedings and the voting and acceptance of proposals and concludes that neither mechanism addresses the collective action problem. He proposes a simpler, albeit hypothetical, model that addresses the problem and incorporates certain features of the Code, such as the cram down and the prepackaged plan. He does not conduct a comparative doctrinal analysis of these concepts but merely uses them for illustrative purposes. Professor Triantis also points to certain difficulties arising out of the wholesale adoption of the extensively regulated system of Chapter 11.

25 Ibid. at 587.

26 Supra note 1 and accompanying text.

Professor Douglas G. Baird questioned the wisdom of Professor Triantis' suggestion that Canada move along the reorganization spectrum toward a Chapter 11 model. Professor Baird's article does not analyze the doctrinal or normative bases of the Canadian and American business reorganization provisions. Rather, he provides a critique or, more accurately, a criticism of Chapter 11. We must temper any suggestion of adopting certain features of another system with the concerns raised by those living under the system. Accordingly, this paper will refer to Professor Baird's thesis throughout the discussion that follows.

This paper will expand upon the notion put forth by Triantis and Edwards that certain features of the Code be incorporated into the Canadian business reorganization regime. However, rather than looking at a business reorganization system as a rationale for the mitigation of the collective action problem, this paper will treat the distributional objective of balancing debtor and creditor rights, along with the objective of rehabilitation of the debtor, as the primary objectives of a business reorganization system. These objectives provide the normative platform upon which to build a business reorganization system. One may take the position that business reorganizations are desirable and that the rights of the debtor (and hence, the reorganization itself) should take precedence over the rights of the creditors. However, one can hardly make an argument that business reorganizations are desirable in every situation. Conversely, it is equally erroneous to suggest that business reorganizations should not be a part of a commercial system, as certain businesses should have the opportunity to adapt to the changing circumstances in the marketplace. To that extent, the system may modify the strict rights of creditors. A system that favours neither the debtor nor its creditors but attempts to balance the interests of each is one that we should seek to attain. In attempting to strike such a balance, the respective positions of the parties that have the least to gain should not be sacrificed. Conversely,

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28 Baird, supra note 14. This article was prepared and published at the same time as the foregoing article by Professor Triantis.

29 Professor Triantis considers bankruptcy law as attempting to achieve efficiency rather than balancing the rights of debtor and creditor, given that the parties consider the distributional impact of bankruptcy rules long before the rules become operative.
those that may prosper from a successful reorganization should be made to incur the risks of the reorganization proceeding.\textsuperscript{30}

\section*{C. METHODOLOGY}

This work will use, in a very general way, the methodology suggested by Edwards, although it will not stress the public policy objectives upon which Edwards based his work. Since his article, the Canadian and American systems have developed sufficiently to justify a doctrinal analysis of the concepts that have evolved. This type of analysis will allow us to determine whether we have realized the "great potential importance" of the CCAA and business reorganization laws, foreshadowed by Edwards.\textsuperscript{31}

It would however, be naive to think that one could study a topic dealing with business reorganizations, insolvent business debtors and potential loss of jobs, through a purely doctrinal analysis, without some type of policy analysis. The normative values underlying a business reorganization system will significantly affect the nature of this analysis. This will be an important aspect of this discussion, as it appears that the Parliament of Canada left the development of a business reorganization system to the courts. With respect, the courts should not be required to bear this burden. The legislation should have reflected the broad policies sought to be accomplished. Courts face only the very narrow issues that come before them and must resolve those issues without being required or permitted to establish broad, seemingly unrelated policies. Furthermore, the courts have limited sources of information from which to draw, compared to the vast resources available to the policymakers.\textsuperscript{32} Without clearly articulated policies, as reflected in the legislation, it may take

\begin{itemize}
\item \textsuperscript{31} Edwards, supra note 1 at 587.
\item \textsuperscript{32} R.A. Heineman, ed., \textit{The World of the Policy Analyst} (Chatham: Chatham House, 1990) at 141-169.
\end{itemize}
years to realize those policies or they may never be realized, should the precise issue not come before the courts. \(^{33}\)

The specific methodology to be undertaken will be one of comparative analysis of the proposal provisions of the BIA, the reorganization and certain administrative provisions of the Code and the CCAA. This methodology raises several issues that must be dealt with before embarking on the examination. Given the differences in the structures of the respective regimes it is difficult to overlay one system on another. Therefore, this paper will undertake functional comparisons of similar mechanisms to illustrate the necessity of conducting a comprehensive review of the Canadian system. A purely descriptive approach will be avoided, although some description will be necessary. Rather, an "applied comparative law" \(^{34}\) approach will be undertaken. Such an approach does not merely describe the laws being considered or their differences, but is a functional comparison of the mechanisms and concepts used in each system. \(^{35}\) As part of this examination, a brief review of the legislative histories of the statutes under consideration will be made. This may give us some insight as to the legal and social causes underlying the differences in the reorganization regimes.

There are several reasons for employing this methodology, at this time. First, the provisions of the Code have been operative for over fifteen years, which has resulted in a body of case law. This case law may assist us in determining whether the objectives of the American policymakers in enacting Chapter 11 have been realized in practice. Furthermore, this approach may point to positive and negative aspects of the Code and may assist us in formulating proposals for reform that are lucid and accomplish the desired objectives. \(^{36}\) As well, because of the perception that the Canadian


\(^{34}\) H.C. Gutteridge, Comparative Law (Cambridge: Cambridge University Press, 1946) at 9.

\(^{35}\) Ibid

\(^{36}\) It has been said of this type of methodology that:

"To study the way other systems at comparable stages of development deal with problems that
reorganization regimes are evolving into a system similar to the American model, \(^{37}\) examining the American model may assist us in interpreting and understanding the current Canadian systems. Finally, the United States continues to be the major trading partner of Canada and the level of trade will undoubtedly continue or escalate under the Canada-U.S. Free Trade Agreement\(^{38}\) and the North American Free Trade Agreement.\(^{39}\) If both countries reexamine their respective business reorganization regimes with a view to harmonizing the provisions, the expectations of creditors involved in cross-border insolvency proceedings may be more expeditiously and equitably realized.

While each of the statutes that will be considered in this paper may be traced back to English statutes and case law,\(^{40}\) this paper will make only passing reference to those laws. Alan Watson described the importation of rules or systems of law from one country to another as a "legal transplant"\(^{41}\) and developed an analogy to describe the level of acceptance of the transplant:

A successful legal transplant - like that of a human organ - will grow in its new body, and become part of that body just as the rule or institution would have continued to develop in its parent system. Subsequent development in the host system should not be confused with rejection.\(^{42}\)

An interesting question is why business reorganization law continued to develop in the United States our own system either does not handle very well or to which we have not yet worked out satisfactory solutions, is often extremely enlightening. Comparatists do not ordinarily view this sort of study as preliminary to wholesale transplantation of a foreign institution, but rather as a source of inspiration, and an indication of the problems, as well as the benefits, to be anticipated with using alternative models. [M.A. Glendon, M.W. Gordon and C. Osakwe, *Comparative Legal Traditions* (St. Paul: West, 1985) at 14].

\(^{37}\) *Supra* note 12.

\(^{38}\) Ottawa: Department of External Affairs Canada, 1987.

\(^{39}\) Ottawa: Minister of Supply and Services Canada, 1992.


\(^{42}\) *Ibid* at 27.
whereas in Canada, neither the former Canadian Act nor the CCAA were used to any great extent prior to the early 1980s. In 1947, Edwards attributed the lack of Canadian reorganization law to Canada's relatively immature economic development. This however, does not explain why, since that time, business reorganizations in Canada continued to lie dormant while American reorganization law was flourishing. Certainly, it did not take Canada to the early 1980s to reach the economic development of the United States in the 1940s.

A comparative analysis approach is also fraught with the danger of ethnocentricity or a suggestion that one law is a superior or exemplary regime. Hopefully, a paper which suggests that none of the systems is entirely satisfactory may not be accused of either.

This brings us to perhaps the most vexing problem in undertaking a comparative analysis involving foreign legislation. In the first instance, one must familiarize oneself with the legislation. This requires not only a review of the legislation, but also a review of certain cases and commentaries interpreting that legislation. It is dangerous to assume that the approaches taken by scholars and the judiciary are completely objective and as such, there is some difficulty in exercising autonomy in the interpretation of the legislation. In combatting this difficulty however, the reader must remember that the object of this paper is not to provide a critique of the American system, but to use American materials as a benchmark from which to determine whether the Canadian courts and legislators would benefit from adopting a similar approach. In this manner, the commentaries on the American legislation will be invaluable. This paper will also refer to the Senate Report and the House Report, where appropriate, in an attempt to determine the legislative intent of the Code. This not only will assist in interpreting the provision being considered, but also may be useful in giving us insight into the social objectives that the legislation sought to accomplish. The aim in reviewing the American law is not to determine whether the system is inherently good or bad, but whether aspects of it help to accomplish the broader objectives of a business reorganization system.

43 "There was little reorganization law in America when its economic development was at a stage comparable to Canada's present condition." [Edwards, supra note 1 at 592].
This approach is not meant to suggest that a uniformity of business reorganization laws is possible or advisable. To make such a suggestion, it would be necessary to examine broader nonbankruptcy matters such as regimes involving real and personal property security and macroeconomic factors. This broader examination is beyond the scope of this paper.

One final issue concerning the approach to be taken in conducting research on a topic that affects a broad range of individuals and entities in the business community must be addressed. As mentioned above, one purpose of insolvency legislation is to attempt to balance the interests of the various parties involved in the proceeding. An attempt has been made to attain scholarly objectivity in conducting the research. However, depending on the position of the reader, the results of the research may be seen as biased in favour of one or more parties. For example, in discussing the concept of adequate protection under the Code, it has been said that:

In resolving the conflict, many bankruptcy courts appear to give undue deference to the secured creditor's rights, leading them to impose standards of adequate protection that seriously impede and often arrest the debtor's reorganization.

On the other hand, some writers see the concept of adequate protection as one which favours the debtor such that "the balance is usually in favour of the debtor so as to effectuate the underlying bankruptcy policy of rehabilitation."

This merely illustrates the danger in assuming that the research will be seen as objective, despite the lofty aim of objectivity. In fact, the legislation itself may be value-laden as it may not truly reflect the best interests of the business community as a whole. The committee that prepared the Tassé Report stated that it was not a committee of inquiry or investigation, although it solicited

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44 Supra note 29 and accompanying text.


47 Tassé Report at xi.
information from registrars and official receivers and interviewed judges, registrars, official receivers, trustees, lawyers and law teachers. In addition, a number of parties, a partial list of which appeared as an appendix to the Tassé Report, made written submissions. Only one party specifically represented debtors. One must question whether the Tassé Report fairly represented the position of debtor and accordingly, whether the legislation that resulted serves the needs of society as a whole.

C. 'BUSINESS REORGANIZATION'

This paper is concerned with business reorganizations under Chapter 11, compromises and arrangements under the CCAA and proposals under division I of part III of the BIA. The term "reorganization" or "business reorganization" will be used to designate these procedures. This paper specifically avoids use of the term "corporate reorganization," as the Code and the BIA also apply to individuals and partnerships that are carrying on business. Excluded from the term are consumer proposals or arrangements, arrangements involving farmers and farm corporations, plans for adjustment of a municipality and railroad reorganizations or schemes of arrangement.

Although one may define a business reorganization in terms of the objectives that it seeks to accomplish, it may be more appropriate to define it by its intrinsic nature. For the purposes of this paper, "reorganization" or "business reorganization" means a judicially-supervised settlement between a debtor and its creditors and among the debtor's creditors concerning the financial affairs of the

48 It is acknowledged that submissions were made by organizations such as the Canadian Bar Association and La Chambre de Commerce du District de Montréal, which may have addressed the interests of debtors but overwhelmingly, the written submissions were from interest groups representing creditors.

49 Division II of part III of the BIA and chapter 13 of the Code.

50 Farm Debt Review Act, R.S.C. 1985, c. 25 (2d Supp.) and chapter 12 of the Code.

51 Chapter 9 of the Code.


53 Honsberger, supra note 21 at 1-21.
debtor. The reorganization seeks to solve the problem of how to make a debtor in failing circumstances economically sound, while at the same time preserving or modifying the legal rights of its creditors and shareholders.\textsuperscript{54}

\textsuperscript{54} Collier on Bankruptcy, vol. 1, 14th ed. (New York: Matthew Bender, 1974) s. 0.01.
CHAPTER II

LEGISLATIVE HISTORY

This chapter will provide a brief legislative history of each system being considered in this paper. Placing the provisions within a historical context may provide an indication of the interests sought to be protected at the time of their enactment. It may also assist a contemporary law reformer in determining whether those interests continue to require protection or alternatively, whether current values require protection of different interests.

A. BIA

The first bankruptcy legislation enacted by the Parliament of Canada was the Insolvent Act of

1 This chapter will deal with the legislative history of business reorganization legislation generally. Throughout this paper, reference will be made to the legislative history of the particular provisions under consideration.

2 Bankruptcy laws and specifically, business reorganization laws, are promulgated pursuant to the respective jurisdictions granted to the federal governments of the United States and Canada under their constitutions. Subsection 91(21) of Constitution Act, 1867, (U.K.), 30 & 31 Vict., c. 3 [hereinafter the Canadian Constitution], delegates to the Parliament of Canada legislative authority over bankruptcy and insolvency. Similarly, the Constitution of the United States of America, 1 Stat. 10 (1845) [hereinafter the U.S. Constitution], grants Congress the power to establish "uniform Laws in the subject of Bankruptcies throughout the United States" [art. I, s. 8, cl. 3].

The courts have placed few limits on the extent of the bankruptcy power. The District Court of Missouri stated:

"I hold it extends to all cases where the law causes to be distributed the property of the debtor among his creditors; this is its least limit. Its greatest is a discharge of the debtor from his contracts. And all intermediate legislation, affecting substance and form, but tending to further the great end of the subject - distribution and discharge - are in the competency and discretion of congress." [In re Klein, [1843] Fed. Cas. 716 at 718 (D. Mo.)].

If there are inconsistent or conflicting federal and provincial or state laws, the federal laws will prevail or pre-empt the provincial or state law. This is based, in Canada, on the federal paramountcy doctrine [Tennent v. Union Bank, [1804] A.C. 31 (P.C.)] and, in the United States, on the "supremacy clause" in the U.S. Constitution, that provides:

"This Constitution, and the Laws of the United States which shall be made in Pursuance thereof ... shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding." [art. VI, s. 2]
1869. That act contained provisions allowing an insolvent debtor to make a composition with its creditors. These doctrines are applicable when the federal law and the provincial or state law are valid and enacted within each government's delegated or residual authority, but they yield inconsistent or conflicting results [P.W. Hogg, Constitutional Law of Canada, 3d ed. (Toronto: Carswell, 1992) at 418]. A recent challenge to the commercial tenancy provisions in Part III of the BIA was undertaken in Re Jarpan Inc. (1993), 20 C.B.R. (3d) 8 (C.S. Qué.), where the court upheld those provisions on the basis of the federal paramountcy doctrine.

The Canadian and American courts have upheld the jurisdictions of the Parliament of Canada and Congress to enact legislation providing for compositions, extensions and reorganizations under their respective bankruptcy powers. The constitutionality of a provision permitting the debtor to effect a compromise of its debts with its creditors was upheld on the basis that the bankruptcy power was nothing less than "the subject of the relations between an insolvent or non-paying or fraudulent debtor and his creditors, extending to his and their relief." [In re Reiman, 20 Fed. Cas. 490 at 496-497 (No. 11, 673) (S.D.N.Y. 1874)]. The constitutional validity of the rehabilitative methods from composition of unsecured claims to reorganization and adjustment of secured claims has also been upheld.

The CCAA was upheld in a reference case to determine its constitutional validity. In Re Companies' Creditors Arrangement Act, [1934] S.C.R. 659 [hereinafter CCAA Reference], Duff C.J. stated that:

"The history of the law seems to show clearly enough that legislation in respect of compositions and arrangements is a natural and ordinary component of a system of bankruptcy and insolvency law." [at 660]

The Alberta Court of Queen's Bench recently had occasion to consider the constitutionality of the CCAA in Norcen Energy Resources Ltd v. Oakwood Petroleums Ltd (1988) 72 C.B.R. (N.S.) 1 (Alta. Q.B.). The court made certain comments that may foreclose any challenges to the constitutionality of reorganization statutes generally. In discussing the CCAA Reference case, Forsyth J. said:

"The C.C.A.A. is an Act designed to continue, rather than liquidate, companies. In upholding the C.C.A.A., the Supreme Court of Canada must be taken as having extended the meaning of the term "insolvency" to include dealing with insolvent companies outside of a liquidation setting. The critical part of the decision is that federal legislation pertaining to assisting in the continuing operation of companies is constitutionally valid. In effect the Supreme Court of Canada has given the term "insolvency" a broad meaning in the constitutional sense by bringing within that term an Act designed to promote the continuation of an insolvent company." [at 15-16].

S.C. 1869, c. 16.

Although the term business reorganizations, as used in this paper, includes compositions, extensions and schemes or plans of arrangement, early legislation referred only to compositions. A composition is an arrangement between the debtor and its creditors where the creditors agree with the debtor and among themselves to take less than the full amount of their respective claims on a pro rata basis in full satisfaction of the debts due or accruing due to them from the debtor [Black's Law Dictionary, 6th ed. (St. Paul: West, 1990) at 286]. It is important to note the difference between common law compositions and compositions created by statute. In the case of a statutory composition, the statute allows the majority to bind the minority to the composition. For example, section 94 of the Insolvent Act of 1869, ibid., provided:
creditors. The Insolvent Act of 1875 repealed the Insolvent Act of 1869. The Insolvent Act of 1875 contained provisions similar to those repealed. These acts applied only to insolvent traders. Because of the number commercial failures resulting from the depression in Canada between 1874 and

"A deed of composition and discharge, executed by the majority in number of those of the creditors of an Insolvent who are respectively creditors for the sums of one hundred dollars and upwards, and who represent at least three fourths in value of the liabilities of the Insolvent subject to be computed in ascertaining such proportion, shall have the same effect with regard to the remainder of his creditors, and be binding to the same extent upon him and upon them, as if they were also parties to it;"

Conversely, in a common law composition, a non-accepting creditor need not be bound by the agreement of others.

In the context of a business reorganization, an extension is an agreement between the debtor and its creditors where, in consideration of the creditors agreeing not to enforce their rights to collect the debts owing by the debtor for a period of time after the debts are due, the debtor agrees to pay the debts in full within that period [Tassé Report at 93].

Finally, a scheme of arrangement, in strict terms, includes any arrangement where the property or income of a debtor is proportionately applied to its debts [R. Bird, Osbourn's Concise Law Dictionary, 7th ed. (London: Sweet & Maxwell, 1983) at 297]. The assets of the debtor are transferred or assigned to a trustee who administers the scheme [M. Crystal and B. Nicholson, Bankruptcy and Deeds of Arrangement Law and Practice (London: Oyez, 1978) at 59; L. Duncan and J.D. Honsberger, Bankruptcy in Canada, 3d ed. (Toronto: Canada Law Book, 1961) at 261]. Other than the distinguishing feature of the third party intermediary, it appears that a scheme of arrangement could have the substantive features of an extension or composition.

Although the definition of "proposal" in the BIA includes a proposal "for a composition, for an extension of time or for a scheme of arrangement" [BIA s. 2 "proposal"] and the CCAA allows the debtor company to make a "compromise or an arrangement"[CCAA ss. 4 and 5] with its creditors, these terms are of historical significance only, as "in actual practice the court is not greatly concerned whether the proposal falls into one of these . . . headings or is a combination of them" [L.W. Houlden and C.H. Morawetz, Bankruptcy and Insolvency Law of Canada, 3d ed. (Toronto: Carswell, 1994) at 2-74]. This paper has chosen to use the words "business reorganization" to denote one or all of these types of arrangements. This term is broader than the three terms used in the BIA, as it encompasses the potential of there being fundamental changes to both the debt and the equity structures of the debtor, including the elimination of some interests. The current practice of the courts appears to treat proceedings under all of the legislative schemes being examined in this broad manner. However, when the terms composition, extension and scheme of arrangement are used in this chapter, they shall have the strict, narrow meanings described above.

5 Insolvent Act of 1869, supra note 3 ss. 94-108.

6 S.C. 1875, c. 16.

7 Ibid. ss. 149 and 151.

8 Ibid. ss. 49-66.

9 Section 1 of both acts.
1878, public discontent with legislation that permitted "dishonest and designing debtors" to escape their liabilities,\(^{10}\) led to the passage of *An Act to repeal the Acts Respecting Insolvency now in force in Canada*.\(^{11}\) A further reason for the repeal was the "constant irritation caused by ill-considered legislative tinkering with so important a piece of legislation."\(^{12}\) Canada was without bankruptcy legislation until 1919, when the *Bankruptcy Act*\(^{13}\) was passed. The 1919 Act enlarged the scope of proposals that an insolvent debtor could make to its creditors to include, not only compositions, but also extensions and schemes of arrangement.\(^{14}\) In 1923, Parliament passed *The Bankruptcy Act Amendment Act, 1923*.\(^{15}\) Section 15 of that act repealed section 13 of the 1919 Act and replaced it with a provision allowing only a bankrupt to make a proposal. This amendment resulted from allegations that debtors were avoiding bankruptcy by securing creditor consent to a proposal through bribes and other fraudulent means.\(^{16}\)

Parliament repealed the 1919 Act in 1949\(^{17}\) and replaced it with the 1949 Act.\(^{18}\) It appears that Parliament intended to clarify bankruptcy legislation by the passage of the 1949 Act. When the bill was introduced to the Senate, the Honourable J. Gordon Fogo said "[t]he bill provides a more orderly arrangement of subjects and the language in many sections of the Act has been simplified."\(^{19}\) For our

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\(^{10}\) *House of Commons Debates* (19 February 1880) at 102.

\(^{11}\) S.C. 1880, c. 1.

\(^{12}\) Duncan and Honsberger, *supra* note 4 at 17.

\(^{13}\) S.C. 1919, c. 36 [hereinafter the 1919 Act].

\(^{14}\) 1919 Act s. 13(1).

\(^{15}\) S.C. 1923, c. 31.

\(^{16}\) Tassé Report at 19.

\(^{17}\) *Bankruptcy Act, 1949*, S.C. 1949, c. 7 [hereinafter the 1949 Act], s. 173.

\(^{18}\) *Ibid*.

\(^{19}\) *Debates of the Senate* [6 October 1949] at 98.
purposes, the most notable change was the reinstatement of the provision allowing an insolvent person to make a proposal, without being bankrupt. The 1949 Act was criticized as inefficient, obsolete and incapable of dealing with fraudulent bankruptcies.20 Thus, in 1966, Parliament made significant amendments to the 1949 Act by the Act to amend the Bankruptcy Act.21 Among other things, the amendments gave the court the right to appoint an interim receiver22 and provided that the insolvent person would be considered bankrupt on the refusal of the creditors or the court to accept or approve the proposal.23

In 1966, steps were also taken toward the process of amending Canada's bankruptcy regime, with the formation of the Study Committee on Bankruptcy and Insolvency Legislation. The committee presented the Tassé Report to the Minister of Consumer and Corporate Affairs in June of 1970 and recommended the adoption of a new bankruptcy and insolvency statute.24 Since the presentation of the Tassé Report, Parliament made no fewer than six attempts to repeal and replace the former Canadian Act prior to the passage of the amendments that resulted in the BIA.

In 1984, following the sixth failure of Parliament to adopt a new bankruptcy statute, the Minister of Consumer and Corporate Affairs at that time, suggested that it may be more expedient to amend the former Canadian Act.25 The Minister struck the Committee on Bankruptcy and Insolvency that presented the Colter Committee Report in 1986. The Tassé Report and the Colter Committee Report recommended the retention of a system allowing for the reorganization and rehabilitation of

20 Colter Committee Report at 18.
21 S.C. 1966-67, c. 32.
22 Ibid. s. 5.
23 Ibid. ss. 7 and 8
24 Tassé Report at 81.
25 Colter Committee Report at 18.
statements to induce them to accept the proposal being put forth.\textsuperscript{31} As a result, Parliament enacted amendments to the CCAA in 1953\textsuperscript{32} that required the debtor company to have issued bonds, debentures or other evidences of indebtedness under a trust deed or other instrument running in favour of a trustee.\textsuperscript{33} However, in recent years, the courts have allowed less than complex debtors to use the CCAA, by permitting them to gain access to its provisions by issuing "instant trust deeds." Therefore, the CCAA is not meeting the legislative intent, although court supervision of proceedings under it may serve to quell any abuses of the legislation.\textsuperscript{34}

C. CODE

The debtor's right to make a composition with its creditors first appeared in the 1874 amendments\textsuperscript{35} to the Bankruptcy Act of 1867.\textsuperscript{36} A debtor could effect a composition without being adjudicated a bankrupt.\textsuperscript{37} In 1878, Congress repealed the Bankruptcy Act of 1867\textsuperscript{38} because of abuses on the part of the courts and excessive fees.\textsuperscript{39} The United States was without bankruptcy legislation for twenty years until the passage of the 1898 U.S. Act.\textsuperscript{40} The composition provisions of the 1898

\begin{footnotes}
\textsuperscript{31} Ibid.
\textsuperscript{32} An Act to amend The Companies' Creditors Arrangement Act, 1933, S.C. 1952-53, c. 3.
\textsuperscript{33} This provision is now CCAA s. 3(a). The types of debtors to whom the CCAA was intended to have application were "companies that have complex financial structures, and a large number of investor creditors." [House of Commons Debates (23 January 1953) at 1269].
\textsuperscript{34} For a discussion of this issue, see chapter III(B), below.
\textsuperscript{35} Ch. 390, 18 Stat. 178 (1874).
\textsuperscript{36} Ch. 176, 14 Stat. 517 (1867) (repealed 1878).
\textsuperscript{37} Collier on Bankruptcy, vol. 1, 14th ed. (New York: Matthew Bender, 1974), s. 0.05.
\textsuperscript{38} Ch. 160, 20 Stat. 99 (1878).
\textsuperscript{39} Collier on Bankruptcy, supra note 37.
\textsuperscript{40} The 1898 U.S. Act was repealed by Pub. L. 95-598, 92 Stat. 2549 (1978), s. 401(a).
\end{footnotes}
U.S. Act were similar to those included in the amendments to the Bankruptcy Act of 1867. A debtor could only make a composition with its unsecured creditors.\(^4\) This limitation curtailed the use of the composition provisions. However, the 1898 U.S. Act did not require the debtor to be insolvent to be eligible to make a composition.\(^2\) Provided the composition met the necessary prerequisites, it could be confirmed by the court\(^3\) and the debtor would be discharged from its debts, following its compliance with the provisions of the composition.\(^6\)

Congress enacted minor amendments to the composition provisions of the 1898 U.S. Act in 1910\(^4\) and 1922.\(^6\) However, major amendments were not made until the onset of the depression that took place in the 1930s. The depression resulted in a significant increase in the number of bankruptcies.\(^7\) As a result, Congress saw a need to amend the provisions of the bankruptcy regime to protect the integrity of the system and allow honest but unfortunate debtors easier access to the system.

\(^4\) Collier on Bankruptcy, supra note 37, vol. 6, s. 0.03.

\(^2\) 1898 U.S. Act s. 4 provided that "[a]ny person who owes debts . . . shall be entitled to the benefits of this Act as a voluntary bankrupt", cf. First National Bank of Cincinnati v. Flershem, 290 U.S. 504 (1934), where the court found that insolvency was neither present nor imminent and, although the court acknowledged that the plan was formulated to provide future benefit to the business, it found that the course of action proposed by the debtor was in "deliberate disregard" of the rights of the affected creditors [at 517]. The court went further however, and found that the purpose sought to be effected by the debtor was "fraudulent in law." [at 519].

\(^3\) 1898 U.S. Act ss. 12 and 13.

\(^6\) 1898 U.S. Act s. 14.

\(^4\) Ch. 412, 36 Stat. 838 (1910), which amended the time at which an offer of composition could be made.

\(^6\) Ch. 22, 42 Stat. 354 (1922), which added the necessity of an indemnity for any losses suffered as a result of the delay in adjudication resulting from the presentation of a composition.

\(^7\) In his address to Congress in 1932, President Hoover outlined the following staggering statistics:

"The number of cases in bankruptcy has steadily increased from 23,000 in the fiscal year 1921 to 53,000 in 1928 and to 65,000 in 1931. The liabilities involved have increased from $171,000,000 in 1921 to $830,000,000 in 1929 and to $1,008,000,000 in 1931, and the losses to creditors have increased from $144,000,000 in 1921 to $740,000,000 in 1928 and to $911,000,000 in 1931." [reprinted in, Collier on Bankruptcy, supra note 48 at s. 0.06]
and more expeditious relief. Unfortunately, the time required to study the existing system and make recommendations necessitated the passage of "emergency" legislation in the mid-1930s.

The legislation that preceded the enactment of the emergency legislation, permitted only compositions. It did not permit a comprehensive reorganization of the debt and capital structures of the debtor to facilitate its ongoing operation. Among other things, the emergency legislation attempted to accomplish this. For our purposes, the addition of section 77B was the most significant amendment effected by the emergency legislation, as it was the first comprehensive code for the reorganization of corporate debtors.

Section 77B laid the groundwork for the reorganization provisions that evolved into Chapter 11. It provided that on acceptance of a plan by special majorities of creditors and stockholders, the

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48 Ibid.

49 W.J. Blum and S.A. Kaplan, Corporate Readjustments and Reorganizations (Mineola: Foundation Press, 1976) at 185. Prior to the enactment of section 77B, corporate reorganizations were accomplished through a device known as the equity receivership. An equity receivership was commenced by a creditor whose execution had been returned unsatisfied. The creditor would seek the court's assistance in having a receiver appointed to take control of and, ostensibly, sell the debtor's assets to satisfy the creditors. However, once a receiver was appointed, the debtor and the creditors could formulate a plan that would see the debtor's assets sold and the rights and obligations of the parties adjusted with a view to having the former business of the debtor continue, as reorganized [for a full discussion of equity receiverships, see Collier on Bankruptcy, supra note 37, vol. 6, s. 0.04]. Although equity receivership was an adequate device for reorganization, it possessed many inadequacies that section 77B attempted to rectify. The inadequacies were summed up by the United States Supreme Court, where Goldberg J. said:

"Before passage, in 1934, of s. 77B of the Bankruptcy Act, 48 Stat. 912, bankruptcy procedures offered no facilities for corporate rehabilitation, which, therefore, was left to equity receiverships, with their attendant paraphernalia of creditors' and security holders' committees, and of rival plans of reorganization. Lack of judicial control of the conditions attending formulation of the plans, inadequate protection of widely scattered security holders, frequent adoption of plans which favoured management at the expense of other interests and which afforded the corporation only temporary respite from financial collapse, so often characteristic of equity receivership reorganizations, led to the enactment of s. 77B. . . . As does the present: Chapter X, s. 77B permitted the adjustment of all interests in the debtor, secured creditors, unsecured creditors, and stockholders." [Securities and Exchange Commission v. American Trailer Rentals Co., 379 U.S. 594 at 603-604 (1965) [hereinafter American Trailer Rentals]].
plan would be binding on the dissenting minority.\textsuperscript{50} It also provided for the classification of claims,\textsuperscript{51} the stay of proceedings,\textsuperscript{52} the continuation of the debtor in possession in the absence of the appointment of a trustee\textsuperscript{53} and allowed the court to make an independent determination concerning the fairness of the plan.\textsuperscript{54}

However, section 77B lacked provisions for the protection of creditors and investors and supervision of the business of the debtor during the reorganization procedure.\textsuperscript{55} Accordingly, Congress passed the Chandler Act in 1938. Section 77B essentially became Chapter X, which governed corporate reorganizations. The theory underlying Chapter X was that the actual parties in interest, being the creditors and the stockholders, would control the reorganization process.\textsuperscript{56} It also provided for the mandatory appointment of an independent trustee to monitor the affairs of a large debtor during the reorganization\textsuperscript{57} and a more comprehensive means of control by the courts during the reorganization process.\textsuperscript{58} One of Chapter X's strengths was in permitting the debtor to reorganize and compromise the interests of unsecured and secured creditors, and stockholders. However, the

\textsuperscript{50} 77B(e).
\textsuperscript{51} 77B(c)(6).
\textsuperscript{52} 77B(c)(10).
\textsuperscript{53} 77B(c)(1).
\textsuperscript{54} 77B(f)(1).
\textsuperscript{57} Chandler Act s. 156 provided:

"Where the liquidated and non-contingent indebtedness of a debtor is $250,000 or over, the judge shall, upon the approval of the petition, appoint one or more disinterested trustees, who shall be qualified, except as to residence and location of office, as prescribed in section 45 of the Act. Where such indebtedness is less than $250,000, the judge may appoint one or more trustees or may continue the debtor in possession."

\textsuperscript{58} American Trailer Rentals, supra note 49 at 604.
provisions were intended for large publicly-held corporations that needed readjustment of secured
debt.  

The Chandler Act also created a new procedure under Chapter XI, known as an "arrangement."  
Chapter XI was designed for use by individuals and corporations other than those to whom the
provisions of Chapter X applied.  As Chapter XI permitted a debtor to reorganize its affairs only
with its unsecured creditors, it suffered the same weakness as the former Canadian Act.  The plan
could not affect secured creditors.  One commentator explained the rationale for excluding secured
creditors from the provisions of Chapter XI as follows:

The policy of dealing with secured debts was unsound; it was soon recognized that the
interference with the free exercise by secured creditors of their remedies was bound ultimately
to impair the liberal extension of credit upon collateral.  Besides, its provisions were
ineffective; in the majority of cases ... the secured indebtedness was a single debt held by a
single person and in an amount sufficient to constitute a substantial, if not the major, part of
the indebtedness.  Such a secured creditor held and frequently exercised a virtual veto power
over the proceeding.

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59 Collier on Bankruptcy, supra note 37 at s. 0.09.  In this manner, the focus of Chapter X was
the same as the intended focus of the CCAA.  Under Chapter X, public investors were protected by
the intervention of the Securities and Exchange Commission.  See e.g., Chandler Act s. 172 which
provided:

"After hearing and before approval of any plan, the judge may, in cases in which the
scheduled indebtedness does not exceed $3,000,000 and shall, in cases in which the scheduled
indebtedness exceeds $3,000,000, refer to the Securities and Exchange Commission for
examination and report the plan or plans deemed by him worthy of consideration.  Such report
shall be advisory only."

60 Chandler Act s. 147, provided:

"A petition improperly filed under this chapter, because adequate relief can be obtained by the
debtor under chapter XI, may upon the debtor's application, be amended to comply with the
requirements for a petition under chapter XI, and thereupon shall be regarded as if originally
filed thereunder."

See also Chandler Act ss. 146(2) and 141 which together, provided that a court may dismiss a petition
that is filed under Chapter X if adequate relief would be obtainable by the debtor under Chapter XI.

61 Weinstein, supra note 56 at 259.

62 Ibid.

63 Ibid. at 260.
The provisions of Chapter XI were much less stringent than those of Chapter X, given the interests to be served by Chapter X. Despite the intent of Congress, it appeared that a corporation had a choice of regimes under which it could attempt to effect a reorganization. The United States Supreme Court held that the consideration controlling the choice of regime was not the character of the debtor, the nature of its capital structure or its size, but the nature of the interests and the needs to be served in the rehabilitation of the debtor.\textsuperscript{64} Although generally, Chapter X was intended for adjustment of publicly-held debt,\textsuperscript{65} the courts allowed larger, publicly-held corporations to use Chapter XI.\textsuperscript{66} However, on application of the Securities and Exchange Commission, the court had the discretion to dismiss a Chapter XI proceeding, unless the debtor complied with the more stringent requirements of a Chapter X proceeding.\textsuperscript{67} Despite these procedures, fewer that 10 percent of all reorganizations were commenced under Chapter X. Debtors used the the less rigorous provisions of Chapter XI more frequently.\textsuperscript{68}

The House Report\textsuperscript{69} referred extensively to the shortcomings of having two reorganization chapters and summarized its position as follows:

\begin{quote}
In sum, any justification that existed in 1938 for two reorganization chapters has disappeared. Chapter X has become an unworkable procedure, and chapter XI is inadequate to fill the void. Chapter X needs to be made more flexible, both in terms of procedure and financial standards
\end{quote}

\textsuperscript{64} General Stores Corp. v. Shlensky, 350 U.S. 462 (1956).

\textsuperscript{65} American Trailer Rentals, supra note 49 at 613.

\textsuperscript{66} See e.g., In re Transvision, Inc., 217 F.2d 243 (2d Cir. 1954), cert. denied, 348 U.S. 952 (1955).

\textsuperscript{67} 11 U.S.C. 728 (1970). See e.g., In re Lea Fabrics, Inc., 272 F.2d 769 (3d Cir. 1959), where, in describing the scope of the discretion to be exercised by the courts in such a case, Goodrich J. said:

"That discretion, it is to be observed, is not one limited greatly by settled legal rules. . . . But the criterion by which the district judge's discretion is to be exercised has to do with the best arrangement for all parties concerned under the circumstances confronting the particular corporation." [at 771].

\textsuperscript{68} House Report at 222.

\textsuperscript{69} Ibid.
for confirmation. Chapter XI needs to be expanded to permit adjustment of secured debt and equity, and needs to have added certain public protections not now found in chapter XI. As these changes are integrated into the two chapters, the differences between them begin to disappear, and a consolidated business reorganization chapter begins to appear. [The Code] adopts a consolidated chapter for all business reorganizations.70

Thus, Congress adopted the consolidated version of the reorganization chapters as Chapter 11.

70 Ibid. at 223 [citations omitted].
At first blush, the eligibility of an entity to take advantage of a statute allowing it to reorganize its financial affairs may seem like a simple matter. However, the Code, because of its permissive eligibility description, has been creatively used in a way that may seem unusual to Canadian insolvency practitioners. The CCAA and the BIA use more restrictive descriptions.

This chapter will examine the definitional requirements of the legislative schemes with a view to determining whether those requirements encourage or restrict certain entities from using the reorganization opportunities offered by the legislation. Should the conclusion resulting from such examination be that only certain types of entities can take advantage of the opportunity to reorganize, one is confronted with the issue of whether that result meets with the broader objectives of the legislation.

Any enactment that gives one party an advantage over other parties may be subject to abuse. Thus, because the Code and the CCAA give a debtor extensive rights on the commencement of a reorganization proceeding, such as the stay of proceedings, the courts consider whether the debtor must act in good faith in commencing the proceeding. This chapter will examine whether good faith should be considered by the courts and whether the concept supports the objectives of a reorganization proceeding.

A. DEFINITIONAL DIFFERENCES

Subsection 109(a) of the Code allows a person that resides, is domiciled or has a place of business or property in the United States to be a debtor under the Code. Section 109 then provides

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1 See discussion in chapter V(A), below.

2 Code s. 101(41) defines "person" as including an individual, a partnership and a corporation. The definition excludes governmental units, under certain circumstances.
that all persons, other than stock and commodity brokers and certain domestic and foreign insurance companies and banking institutions may be debtors under Chapter 11. The exclusions exist because, in the case of stock and commodity brokers, Congress viewed customer accounts, which are the essence of such entities, as unprotected in a Chapter 11 proceeding. Separate state and federal laws, that contain detailed provisions concerning the insolvency and liquidation of insurance companies and banking institutions, comprehensively supervise and regulate those entities.

The CCAA permits a "debtor company" to propose a compromise or arrangement with its creditors. A company, under the CCAA, includes any federally or provincially incorporated company or any incorporated company having assets or doing business in Canada, wherever incorporated. It excludes certain companies such as banking institutions, railway companies and insurance companies, as applicable federal or provincial law governs their insolvency and liquidation. A debtor company is one that is or is deemed to be insolvent, has committed an act of bankruptcy under the BIA or is bankrupt. Section 3 sets forth the further precondition that there be outstanding bonds issued by the debtor under a trust deed or other instrument running in favour of a trustee.

Subsection 50(1) of the BIA allows a proposal to be made by, inter alia, a bankrupt or an insolvent person. "Insolvent person" is, in turn, defined as a person who resides or carries on

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3 Code ss. 109(b) and (d).


5 House Report at 318; Senate Report at 31.

6 CCAA s. 2 "company".

7 Ibid.

8 CCAA s. 2 "debtor company".

9 Use by the debtor company of an "instant trust deed" to permit its use of the CCAA has been the subject matter of a number of cases and commentaries. This issue will be examined in chapter III(B), below.

10 BIA s. 2 defines a "person" as including a corporation, partnership or unincorporated association.
business in Canada, whose liabilities amount to one thousand dollars and who has ceased paying or is unable to meet its obligations as they become due or whose assets would not be sufficient to pay all obligations that are due and accruing.

The most striking difference between the Canadian and American reorganization regimes is the absence of a requirement in the Code that the debtor be insolvent or bankrupt at the time the voluntary proceeding is commenced. The Code, therefore, permits seemingly solvent debtors to take advantage of the protective aspects of the Code. Before the enactment of the Code, either the courts or the legislation required the petitioning creditor or debtor to show that the debtor was insolvent at the time of the commencement of the case. The 1898 U.S. Act did not require the debtor to be insolvent, only that it owed debts. However, the United States Supreme Court held that it would be "fraudulent" for a debtor to attempt to take advantage of provisions permitting reorganization if the debtor was solvent.

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11 All of the statutory schemes being considered permit an entity that carries on business in the respective country to seek the relief being offered by the legislation. The CCAA and Code further provide that an entity that merely has assets in that country may use the provisions of the statute. This broad jurisdictional base has caused difficulties in multinational insolvencies. These difficulties will not be considered in this paper but the reader is referred to various treatises and commentaries that consider this issue such as the Tassé Report at 60-62; J.D. Honsberger, Debt Restructuring (Aurora: Canada Law Book, 1994); and the many articles written over a period of approximately five decades by Professor Kurt Nadelmann, commencing with "The Recognition of American Arrangements Abroad" (1941-42) U. Pa. L. Rev. 780 and "Compositions - Reorganizations and Arrangements - in the Conflict of Laws" (1948) 61 Harv. L. Rev. 804.

12 BIA s. 2 "insolvent person".

13 A voluntary case is commenced under section 301 of the Code by the debtor filing a petition with the bankruptcy court. An involuntary case is commenced under section 303 of the Code by the requisite number of creditors as provided in subsection 303(b). In order to grant the relief requested in the involuntary petition, the court must be satisfied either that the debtor is generally not paying its debts as they become due or that a trustee, receiver or agent was appointed to take possession of all or substantially all of the property of the debtor for the purpose of enforcing a lien against such property, within 120 days before the filing of the petition. Similarly, a creditor may make the initial application under the CCAA for an order that a meeting of creditors be summoned. The BIA however, does not permit a creditor to commence the proposal proceedings, other than indirectly through a bankruptcy trustee, liquidator or receiver.

14 1898 U.S. Act s. 4, provided that "any person who owes debts . . . shall be entitled to the benefits of this Act as a voluntary bankrupt."
or where insolvency was not imminent or certain.\textsuperscript{15} Section 77B, which was added to the 1898 U.S. Act in 1934, required that the debtor set forth in its petition "facts showing the need for relief under this section; and that the corporation is insolvent or unable to meet its debts as they mature and that it desires to effect a plan of reorganization."\textsuperscript{16} Insolvency was also a requirement under Chapter X and Chapter XI.\textsuperscript{17}

The legislative history of the Code does not suggest the reason for removal of the insolvency requirement, in the case of a voluntary petition. One writer suggested that Congress may have felt that a solvent debtor that was facing financial distress could lose the opportunity to reorganize if it waited too long to commence proceedings.\textsuperscript{18} Also, the removal of the insolvency requirement alleviates a preliminary objection requiring a hearing to determine the financial condition of the debtor. Unless the debtor is clearly insolvent, a hearing to determine the debtor's financial condition could be a lengthy and costly procedure, as it would require the debtor and the objecting party to retain third parties to provide valuations of the debtor's assets and opinions concerning its solvency. Should the debtor be in a tenuous financial condition, the financial and other resources expended on such a

\textsuperscript{15} \textit{First National Bank of Cincinnati v. Flershem}, 290 U.S. 504 (1934) [hereinafter \textit{Flershem}] at 517, 519.

\textsuperscript{16} 77B(a); see \textit{In re Piccadilly Realty Co.}, 78 F.2d 257 (7th Cir. 1935), where the court held that, as a result of the definition of "claim" in section 77B which excluded the claims of stockholders, the debtor was solvent, as the only significant liabilities were those owing to stockholders on account of dividends and amounts owing upon maturity of the stock. Accordingly, the court held that the debtor was not permitted to use section 77B; \textit{cf. In re Kelly-Springfield Tire Co.}, 10 F. Supp. 414 (D. Md. 1935), where the court allowed a solvent debtor to use the provisions of section 77B to help the debtor remain viable and avoid eventual financial demise. In so doing, the court felt that "it is very, very clear that in applying the substance or intention of this Act we do not have to wait until a corporation is absolutely insolvent." [at 417].

\textsuperscript{17} Chandler Act ss. 106(3) and 306(3), respectively. See \textit{e.g.}, \textit{Tucker v. Texas American Syndicate}, 170 F.2d 939 (5th Cir. 1948), where the court held that the petition was not filed in good faith as the debtor, although "cash poor" was "asset rich" and made no effort to borrow money to pay maturing obligations. In other words, the debtor was not insolvent and accordingly, it could not use the provisions of Chapter X. See also \textit{In re Southwest Enterprises, Inc.}, 261 F.Supp. 721 (W.D. Ark. 1966).

\textsuperscript{18} M.S. Bever, "Manville Corporation and the 'Good Faith' Standard for Reorganization Under the Bankruptcy Code" (1983) 14 U. Toledo L. Rev. 1467 at 1495-1497.
procedure could be better allocated to maintaining operations.

To temper the possibility of abuse resulting from the removal of the insolvency requirement, Congress provided the courts with the ability to scrutinize a Chapter 11 proceeding to determine whether to permit it to continue. Paragraph 305(a)(1) of the Code allows the court to dismiss or suspend the reorganization proceeding if the interests of the debtor and the creditors would be better served by a dismissal or suspension. The court also has the ability to permit a party to commence or continue any action that it has against the debtor or debtor's the property by granting relief from the automatic stay. Finally, under subsection 1112(b) of the Code, a case may be dismissed or converted from a reorganization case to a liquidation case, whichever is in the best interests of the creditors and the estate.

In the case of relief from the automatic stay and conversion or dismissal, the court may grant such relief "for cause." Although the Code does not list the debtor's insolvency or good faith as a prerequisite to commencing proceedings under Chapter 11, several courts have concluded that the "causes listed in those sections are not exhaustive and that other causes, such as lack of good faith or the financial condition of the debtor could be examined." A case that raised the concern over the use by solvent entities of the reorganization provisions of the Code and that established the right of such entities to use the protective measures contained in the Code was the case involving Johns-Manville Corporation. When it filed its voluntary petition

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19 Code s. 362(d); see discussion chapter V(A)(4)(b), below.

20 The issue of whether good faith is a prerequisite to commencing and maintaining a reorganization proceeding will be discussed in chapter III(C), below.

21 See e.g., In re Pappas, 17 B.R. 662 at 666 (Bankr. D. Mass. 1982); In re Victory Construction Co., 9 B.R. 549 (Bankr. C.D. Cal. 1981) [hereinafter Victory], modified, 9 B.R. 570, vacated as moot, 37 B.R. 222 (9th Cir. 1984), where the court held that "the debtor's lack of 'good faith' in filing a case under Chapter 11 is 'cause', independent of the existence or lack of adequate protection . . ." [at 560].

under Chapter 11, Manville's net worth exceeded $1.1 billion and its total sales for the immediately preceding year were more than $2 billion. Although there were many reasons for its filing, Manville filed primarily to control and quantify existing and anticipated toxic tort liability claims of victims suffering from asbestos-related diseases. Although solvent at the time of the filing, Manville submitted that the time and expense of litigation and the quantum of the awards would, in the opinion of company officials, leave Manville with no alternative but to liquidate or otherwise dispose of its assets and dismember its business. Commentators have criticized and defended the Manville filing. However, it must remembered that the court upheld the filing. The Bankruptcy Court specifically held that insolvency was not a precondition to filing a voluntary petition under Chapter 11. Moreover, the court upheld the policy "that a financially beleaguered debtor with real debt and real creditors should not be required to wait until the economic situation is beyond repair in order to file a reorganization petition."

We must contrast the Code's eligibility requirements with the Canadian eligibility requirements. Given the restrictive descriptions in the Canadian reorganization statutes, it is unlikely

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24 Ibid. (f. 13).

25 See e.g., Flyer, ibid. at 566-567, where the author said ". . . courts should conclude that a financially healthy corporation which has filed for reorganization for the purpose of escaping tort liability has not filed in good faith. . . . To allow a stable corporate debtor to cloak itself in the protective provisions of chapter 11 would render the chapter a sham."; M. Kunkler, "The Manville Corporation Bankruptcy: An Abuse of Judicial Process?" (1983/84) 11 Pepperdine L. Rev. 151, where the author argues that the filing by Manville was an abuse of the federal bankruptcy law; cf. S. Friedman, "Manville: Good Faith Reorganization or 'Insulated' Bankruptcy" (1983/84) 12 Hofstra L. Rev. 121, where the author argues that because of the future prospect of financial distress and the attempt by Manville to account and provide for the victims whose health problems had yet to manifest themselves, the filing was indeed within the contemplation of the Code and accords with the spirit and intent of Chapter 11.


27 Ibid. at 736.
that a solvent debtor could seek the protection of reorganization. Both statutes require the debtor to be insolvent or bankrupt and it would appear the debtor must be insolvent at the time it commences the proceeding. However, a debtor may be able to devise its eligibility to commence proceedings under the CCAA or the BIA. For example, a debtor company under the CCAA is one that, inter alia, "has committed an act of bankruptcy within the meaning of the Bankruptcy and Insolvency Act".28 One act of bankruptcy under paragraph 42(1)(h) of the BIA is the debtor giving notice to any of its creditors that it is about to suspend payment of its debts. Under the BIA, a debtor could fall within the definition of "insolvent person" by merely ceasing to pay its current obligations in the ordinary course of business as they generally become due.29 The BIA says nothing concerning the inability of the debtor to make such payments, only that the payments have ceased. Whether devising its eligibility to propose a compromise or arrangement under the CCAA or to file a proposal or a notice of intention to file a proposal under the BIA breaches any good faith requirement30 does not derogate from the fact that, on a strict reading of the statutes, the debtor is qualified to use the provisions.

Although one may attempt to argue that the possibility of massive tort liability in Canada is remote, given the size of awards made by Canadian courts or the fact that Canadian industry is simply not as large as that carried on in the United States, the possibility of such liability exists in Canada. Furthermore, debtors are using the CCAA for purposes that were likely not contemplated by the policymakers, such as the downsizing of operations by disclaiming leases of unprofitable locations.31

In appropriate circumstances, other strategic advantages could be gained by using the CCAA, such

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28 CCAA s. 2 "debtor company"(b).
29 BIA s. 2 "insolvent person"(b).
30 See discussion infra notes 71-89 and accompanying text.
31 E.g., the case involving Silcorp Ltd. involved a substantial downsizing where the court permitted the debtor to repudiate a substantial number of leases of unprofitable premises. The issue concerning repudiation of real property leases is discussed in chapter V(B), below.
disclaiming other onerous types of contracts.32

Is an insolvency requirement necessary or desirable in a business reorganization regime? The probability or even possibility33 of financial demise is within the contemplation of the objectives of a business reorganization system. Thus, if an entity is facing financial distress, it should be able to take advantage of a reorganization regime, whether or not it is insolvent. However, removal of a requirement of insolvency could present an opportunity for abuse of the system. If removed, the courts should be given the power to scrutinize all of the circumstances of the case to determine whether the proceeding meets objectives of the legislation. It is arguable that despite the solvency of Manville, its filing fell within the intent and spirit of a business reorganization system. Had it not filed, the claims of existing victims could have taken precedence over those victims whose damages had yet to manifest themselves, in the sense that the claims of existing victims may have resulted in Manville's liquidation and dismemberment. By allowing the filing to stand, all of the victims, both existing and future, would be treated equally. However, a debtor that is merely attempting to gain some strategic advantage over its creditors or is seeking the protection of a reorganization statute for some purpose that does not further the objectives of the legislation should not be able to take advantage of its provisions. In such a case, the legislation should be sufficiently flexible to allow for the dismissal of the case. The Code provides that flexibility. The Canadian statutes have yet to be tested in this regard.

B. TECHNICAL REQUIREMENTS UNDER THE CCAA

The CCAA is unique among the reorganization statutes being considered, as it sets forth a

32 For example, in the United States, Chapter 11 has been used by debtors to extricate themselves from obligations under collective bargaining agreements. See e.g., In re Continental Airlines Corp., 38 B.R. 67 (Bankr. S.D. Tex. 1984).

33 It was held in In re U.S.A. Motel Corp., 450 F.2d 499 (9th Cir. 1971), relying on Flesherm, supra note 15, that the debtor's inability to pay its liabilities had to be more than a mere possibility; such inability had to be proved imminent and certain.
Precondition to its application.\(^{34}\) When Parliament first enacted the CCAA, any company incorporated by or under any federal or provincial act or any company having assets or doing business in Canada could use it.\(^{35}\) The 1953 amendment\(^{36}\) attempted to limit the use of the CCAA to widely-held companies with complex financial structures. When the amendment was introduced in the House of Commons for second reading on January 23, 1953, the Honourable Stuart S. Garson, provided the House with a brief rationale for the amendment.

With the passage of this bill it will leave companies that have complex financial structures, and a large number of investor creditors, able to use the Companies' Creditors Arrangement Act for the purpose of reorganization. Moreover, they will be able to use it efficiently; because as a rule, the terms of their own trust deed provide for a trustee of the creditors whose business it will be to look after their interests properly, a provision which is almost invariably absent in the case of the mercantile creditors. The mercantile companies will be able to use the provision of part III of the new revised Bankruptcy Act, which, unlike the Bankruptcy Act in force in 1933, has a provision whereby companies may apply for an extension to work out their affairs without incurring the stigma of bankruptcy.\(^{37}\)

Companies made little use of the CCAA during the first four decades of its existence. One may surmise that the trust deed requirement had the intended effect of limiting its use to certain types of companies.

The 1980s saw a significant increase in the use of the CCAA, although the trust deed requirement did not limit its use to entities with complex financial structures or many investor creditors. Debtors met the precondition by issuing bonds or debentures under trust deeds created immediately before the commencement of the proceeding. The courts allow debtors to use these "instant trust deeds" to meet the condition imposed by section 3. In *Re United Maritime Fishermen*

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\(^{35}\) S.C. 1933, c. 36, s. 2(b). The definition of "company" excluded banks, railway or telegraph companies, insurance companies, trust companies and loan companies.

\(^{36}\) An Act to amend the Companies' Creditors Arrangement Act, 1933, S.C. 1952-53, c. 3, s. 2 [now CCAA s. 3].

\(^{37}\) *House of Commons Debates* (23 January 1953) at 1269.
Co-op, the New Brunswick Court of Queen's Bench specifically held that:

... the words "bona fide" do not appear in section 3 of the Act and that the Court, upon hearing such an application, had no obligation and indeed no rights to raise the issue and determine the validity of the trust deeds.

With respect, one must question the court's rationale in this case. The New Brunswick Court of Queen's Bench, as a court of equity, has the jurisdiction to question the bona fides of any matter before it, whether or not the statute specifically allows for that examination. Despite this criticism, the courts have permitted debtors to seek relief under the CCAA following the issuance of an instant trust deed.

Thus, section 3 merely constitutes a procedural hurdle. Although other reasons exist that may dissuade a debtor from seeking the protection afforded by the CCAA, section 3 does not impose a serious impediment. The effect of this impediment is lessened by the doctrine of reasonable demand and section 244 of the BIA that requires a secured creditor to give the debtor notice of the creditor's

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39 Ibid. at 54 (N.B.Q.B.).


41 See e.g., Elan Corporation v. Cominskey (Trustee of) (1991), 1 C.B.R. (3d) 101, per Doherty J.A. (dissenting in part); Hongkong Bank of Canada v. Chef Ready Foods Ltd. (1991), 4 C.B.R. (3d) 307 (B.C.S.C.), aff'd (1991), 4 C.B.R. (3d) 311 (B.C.C.A.), where the British Columbia Court of Appeal affirmed an order of the British Columbia Supreme Court allowing an application of the debtor for a stay of proceedings under the CCAA notwithstanding the creation of an instant trust deed. The Court of Appeal specifically recognized that the debtor created the trust deed "so as to qualify" under the CCAA [at 313]. Cf. Re Norm's Hauling Ltd. (1991), 6 C.B.R. (3d) 16 (Sask. Q.B.), where the court refused to follow the courts of the other jurisdictions in sanctioning the use of instant trust deeds. In so doing, Wimmer J. stated:

"It is the duty of the court to give effect to legislation, not to emasculate it. The plain language of s. 3 offers no other conclusion than that it was enacted to exclude certain companies from the benefits of the Act. No company is excluded if all that is required is an "entrance fee" in the form of a trust deed created not to raise capital but simply to gain access to a legal remedy not otherwise available. I cannot think that the legislation was intended to be interpreted in a way that permits this. In my opinion, s. 3 contemplated the existence of securities characterized by genuineness in the sense that they were issued to raise capital or secure existing indebtedness and not, as here, to achieve an oblique purpose. To hold otherwise would fail to give effect to the spirit and intent of the legislation." [at 19]
intention to enforce its security. These time periods provide a debtor with ample opportunity to create a trust deed and issue bonds or debentures thereunder. Any reform should remove the requirement of the trust deed. The requirement was originally intended to protect investor creditors by having a trustee monitor the debtor's affairs. A more comprehensive reorganization regime that requires extensive reporting by a debtor in possession or the appointment of a trustee or interim receiver with broad investigative powers could provide this protection. Another alternative may be to create a two-tiered reorganization system; one that deals with more complex entities, the other to deal with the less complex ones. Although this was attempted under the Chandler Act with Chapter X and Chapter XI, it may be workable in a manner similar to that being done in Canada with the BIA and the CCAA.

Like the Code, the flexibility of the CCAA spawns litigation to deal with substantive and procedural matters. This flexibility and the costs attendant on such a proceeding results in the CCAA being used by the larger, more complex entities, in any event.

C. GOOD FAITH IN COMMENCING REORGANIZATION PROCEEDINGS

None of the statutory schemes expressly requires the debtor to be acting in good faith, when commencing a reorganization proceeding. However, the good faith issue arises in a number of situations under the Code and at least one Canadian commentator has suggested that good faith should considered by the courts under the CCAA and the BIA.42

This section will examine the concept of good faith in a business reorganization proceeding. It will then, briefly examine the history of the concept under the American enactments and analyze whether a debtor should be acting in good faith in commencing a reorganization proceeding.

1. The Concept of Good Faith in a Business Reorganization Proceeding

Black’s Law Dictionary defines "good faith" as follows:

Good faith is an intangible and abstract quality with no technical meaning or statutory definition, and it encompasses, among other things, an honest belief, the absence of malice and the absence of design to defraud or seek unconscionable advantage, and an individual's personal good faith is concept of his own mind and inner spirit and, therefore, may not conclusively be determined by his protestations alone.

Honesty of intention and freedom from knowledge of circumstances which ought to put the holder upon inquiry. An honest intention to abstain from taking an unconscientious advantage of another, even through technicalities of law, together with absence of all information, notice, or benefit or belief of facts which render transaction unconscientious. In common usage this term is ordinarily used to describe that state of mind denoting honesty of purpose, freedom from intention to defraud, and, generally speaking, means being faithful to one's duty or obligation.

A Canadian law dictionary adds a further element to the definition of good faith that is relevant to the issue at hand. It states that good faith implies an "absence of ulterior motive." This element is crucial to any determination of good faith of the debtor in commencing reorganization proceedings and requires an examination of the objectives or purposes of a business reorganization regime against the actual, subjective motives of the debtor. In other words, for the debtor to have an ulterior motive, the proper objectives must be manifest. As good faith is a "state of mind," a debtor must be aware of the policies which it is attempting to circumvent, to find that it is lacking good faith.

As none of the statutes censures the commencement of a reorganization proceeding based on the absence of good faith, a debtor may examine the statute and conclude that it falls within its jurisdictional ambit. To find that the debtor lacks good faith, one must go the extra step and find that, although the debtor falls within the jurisdictional ambit of the legislation, it is using that legislation for

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43 Black's Law Dictionary, 6th ed. (St. Paul: West 1990) [citations omitted] [hereinafter Black's].

44 Ibid. at 693. Black's goes on to provide a specific definition of good faith in the context of a reorganization proceeding of an individual. However, the definition refers to a provision of the Code that expressly requires good faith as part of the confirmation process and accordingly, it is inapplicable to the issue at hand.

"inappropriate purposes."  

The analysis must focus on the debtor's honesty, as the concept speaks of honest intention. It must not be based on some objective criteria that would suggest whether there is a reasonable possibility of reorganization. The circumstances may point to factors that would allow the court to glean the subjective intention of the debtor despite its "protestations," but these factors must not derogate from the primary thrust of the examination, which is to determine the debtor's motives.

A primary purpose of a business reorganization statute is to allow the debtor to reorganize its financial affairs to facilitate its rehabilitation, while treating creditors in an evenhanded, fair and equitable manner. If there is no realistic hope of reorganization and the debtor commences the proceeding merely to delay, defeat or defraud creditors, then there is an absence of good faith. However, one must question whether such an analysis truly examines the state of mind of the debtor or whether it is an objective examination of the circumstances of the case to arrive at a conclusion as to the prospects of reorganization or the future viability of the debtor. The timing of such an


47 Black's, supra note 43.

48 But see discussion concerning the good faith standard under Chapter X, infra notes 54-59 and accompanying text.

49 E.g., much has been written on the single-asset cases in the United States, where a debtor transfers a single asset, in which it holds no equity, to an entity that has no other assets, liabilities, employees or active business. This entity subsequently files a Chapter 11 petition. The intent in effecting the transfer is to shield the debtor's active and profitable operations and to delay any foreclosure proceedings through the use of Chapter 11, in the hopes that the property will appreciate in value. It is submitted that a petition filed for this purpose is one that lacks good faith. See e.g., In re Phoenix Picadilly Ltd., 849 F.2d 1393 (11th Cir. 1988) [hereinafter Phoenix Picadilly]; In re Little Creek Development Corp., 779 F.2d 1068 (5th Cir. 1986) [hereinafter Little Creek], in which the court characterized this type of arrangement as the "new debtor syndrome" and observed that it "exemplifies, although it does not uniquely categorize bad faith cases." [at 1073]; In re Nancant, Inc., 8 B.R. 1005 (Bankr. D. Mass. 1981), where the court similarly granted a motion to dismiss the petition. However, the court refused to hold that all new debtor cases would necessarily be dismissed on the grounds of bad faith. [at 1008]; cf. In re Beach Club, 22 B.R. 597 (Bankr. N.D. Cal. 1982), where the court found no bad faith in the filing of the petition on the grounds that there was a legitimate business purpose in the debtor effecting a transfer of the assets to the "new debtor" and the creditors were adequately protected notwithstanding the transfer.
examination is crucial. If the court conducts the examination very early in the proceedings under the CCAA or Code, there may not be sufficient evidence before the court concerning the future prospects of the debtor, such as the possibility of securing additional debt financing or equity capital. Under the BIA, the policymakers have made provision for the filing of a projected cash-flow statement within 10 days after the filing of a notice of intention to make a proposal. This is presumably intended to give the creditors some idea of the debtor's bona fides in filing the notice of intention. However, one must remember that the debtor prepares the projected cash-flow statement and, although a trustee reviews the statement for its reasonableness, the trustee's report is based on assumptions and information provided by management of the debtor and contains language sufficient to exonerate the trustee from any liability other than errors resulting from gross negligence or fraud.

It may be difficult to argue that the courts should sanction the commencement of reorganization proceedings when there is an absence of good faith by the debtor. However, a plain reading of the statutes does not mandate this type of examination.

We now turn to the issue of whether the policymakers deliberately excluded an express mandate to make a determination of good faith from the Code and whether the courts have the statutory or inherent authority to examine this issue at the outset of a reorganization proceeding.

2. Legislative History and Evolution of the Concept of Good Faith in Reorganization Proceedings

The 1898 U.S. Act required good faith as a condition of the court approving a composition following acceptance by the creditors. However, it did not make good faith a prerequisite to the

50 BIA s. 50.4(2).
51 See BIA Form 42.2.
52 1898 U.S. Act s. 12(d) provided:

"The judge shall confirm a composition if satisfied that ... [the composition has been offered] and its acceptance are in good faith and have not been made or procured ... by any means, promises or acts herein forbidden."
commencement of a composition proceeding. In 1933, Congress enacted section 77B which made
good faith a prerequisite to the commencement of the proceeding. Subsection 77B(a) provided:

Upon the filing of such petition or answer the judge shall enter an order either approving it as
properly filed under this section if satisfied that such petition or answer complies with this
section and has been filed in good faith, or dismissing.\(^{53}\)

The Chandler Act repealed section 77B and created Chapter X and Chapter XI to govern
business reorganizations. Only a petition filed under Chapter X had to be filed in good faith.\(^{54}\)

Chapter X provided the following nonexclusive definition of "good faith":

146. Without limiting the generality of the meaning of 'good faith,' a petition shall be
deemed not to be filed in good faith if -
(1) the petitioning creditors have acquired their claims for the purpose of filing the
petition; or
(2) adequate relief would be obtainable by a debtor's petition under chapter XI of
the Act; or
(3) it is unreasonable to expect that a plan can be effected; or
(4) it appears that in a prior proceeding pending in any court, the interests of
creditors and stockholders would be best subserved thereby.\(^{55}\)

For our purposes, subsections 146(3) and (4) are of interest. Subsection 146(4) allowed the court to
dismiss the petition in a two-party dispute between the debtor and one of its creditors. As bankruptcy
only deals with problems involving the collective interests of all or substantially all of the debtor's
creditors, subsection 146(4) would protect the debtor from a petition filed by one of its creditors\(^{55}\) for
an improper purpose,\(^{56}\) such as collection proceedings of the creditor.\(^{57}\) It also protected the creditors

\(^{53}\) Ch. 204, 47 Stat 1467 at 1474 (1933) [emphasis added].

\(^{54}\) Chandler Act s. 144 provided:

"Upon the filing of a debtor's petition, the judge shall enter an approval order if satisfied that
the petition complies with the requirements of this chapter and has been filed in good faith;
otherwise, he shall dismiss it." [emphasis added]

\(^{55}\) Chandler Act ss. 106(8) and (9) allowed a petition to be filed against a debtor by a creditor or
trustee under a trust deed, indenture or mortgage.

\(^{56}\) See e.g., In re South Coach Co., 8 F. Supp. 43 (D. Del. 1934).

\(^{57}\) A petition under the BIA may similarly be dismissed if it is filed for some improper purpose,
such as an attempt by the creditor to use the bankruptcy system as a collection mechanism. See e.g.
and stockholders from a debtor that was merely attempting to obtain some strategic advantage by seeking protection through bankruptcy legislation when state court proceedings were pending.\textsuperscript{58}

Subsection 146(3) of the Chandler Act provided that a petition was deemed not to be filed in good faith if it was "unreasonable to expect that a plan can be effected." This appeared to address the situation of a petition being filed when there was little objective hope that a plan could be effected. As mentioned previously,\textsuperscript{59} a court, in attempting to determine whether the petitioner commenced the proceeding in good faith, must inquire into the petitioner's state of mind. By using the word "expect" in subsection 146(3) of the Chandler Act, Congress was seeking to deal with the state of mind of the petitioner. However, by requiring the court to determine whether the expectation was "unreasonable," the court had to examine objective criteria that would lead to conclusions concerning, not the state of mind of the petitioner, but the state of mind of a reasonable petitioner. Although this type of inquiry derogates from the "pure" concept of good faith that deals with subjective intention, Congress may have been attempting to address the unreasonable expectations and optimism of entrepreneurs in financial difficulty.

Unlike Chapter X, Chapter XI had no good faith filing requirement. It has been argued, however, that the courts implied a requirement of good faith for the filing of a petition under Chapter XI.\textsuperscript{60} \textit{Victory} went further, however, and held that, as the good faith filing requirement was implied into Chapter XI, despite an absence of an express requirement, so too should it be implied into the Code.\textsuperscript{61} Professor Flaccus has recently argued that this conclusion is wrong on the basis that the cases

\textsuperscript{58} \textit{In re Williamsport Wire Rope Co.}, 10 F.Supp. 481 (D. Pa. 1935); \textit{In re Phelps Manor Realty Co.}, 73 F.2d 1010 (3d Cir. 1934).

\textsuperscript{59} See Chapter III(C)(1), above.

\textsuperscript{60} See \textit{e.g.}, \textit{Victory}, supra note 21 at 557, where the court observed "[a]s we have seen, Chapter XI, XII and XIII contained no 'good faith' filing requirement. This 'gap' was filled by the courts!!"; L. Ponoroff and F.S. Knippenberg, "The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy" (1991) 85 Nw. U.L. Rev. 919 at 922-923 (n. 10); H.M. Cohn, "Good Faith and the Single-Asset Debtor" (1988) 62 Am. Bankr. L.J. 131 at 132.

\textsuperscript{61} \textit{Victory}, \textit{ibid.} at 557.
upon which *Victory* relied to support the conclusion, were based on faulty reasoning.\(^{62}\) She concludes that all of the cases cited by *Victory* were considering statutory provisions that made good faith an express filing requirement, such as Chapter X, an express requirement for confirmation of the plan, or other factors listed in section 146. Accordingly, she concludes that a good faith filing requirement should not have been implied as part of Chapter XI in the cases preceding *Victory*. It follows therefore, that if the decision in *Victory* was incorrectly grounded, its conclusion is likely not strong authority. That is, it may be improper to imply a good faith filing requirement into Chapter XI or the Code.

The legislative history also refutes any argument that there is a good faith filing requirement under the Code. The Report of the Commission on the Bankruptcy Laws of the United States\(^{63}\) recommended the elimination of the good faith filing requirement.\(^{64}\) The footnote explaining this recommendation stated:

> The proposed Act . . . allows any party in interest to move the court for an order of dismissal or conversion to liquidation if it is unreasonable to expect that a plan can be effectuated, rather than requiring the court to determine whether good faith exists at an often premature stage and without adequate evidence.\(^{65}\)

In adopting this recommendation, Congress intended to delete a finding of good faith as a precondition to the filing of a petition. It also enacted paragraph 1112(a)(1) which allows a court to convert a Chapter 11 case to a liquidation or dismiss the Chapter 11 case for cause, including, "continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation" [emphasis added]. The "state of mind" element has been deleted. That is, the paragraph speaks of the absence

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\(^{64}\) *Ibid.* at 183.

\(^{65}\) *Ibid.* at 222-223.
of a reasonable "likelihood" of rehabilitation rather than a reasonable "expectation." It is submitted
that the courts, in analyzing this element, must look at all of the circumstances to determine,
objectively, whether rehabilitation is likely, rather than attempt to glean the state of mind of the
petitioner. In other words, it appears that the Congressional intent was not to have the courts
determine the good or bad faith of the petitioner in filing the case. The courts are to make an
objective determination of the likelihood of a successful reorganization, quite apart from the motives
of the petitioner. Accordingly, good faith of the petitioner is not necessary in the filing of a petition
under Chapter 11. The important issue for the courts to consider is not whether the petitioner was
acting in good faith, but whether the objectives of the legislation may be achieved through a
reorganization. Even if the petitioner had ulterior motives in filing the Chapter 11 case, a
reorganization may be the most appropriate means of treating creditors equitably.

Although the list of "causes" that would result in conversion or dismissal is not exhaustive and the court possesses equitable powers to carry out the provisions of the Code, the court should not
be permitted to base its reasoning on a ground that was specifically removed by Congress in enacting
the legislation. Such an approach subverts the legislative grant and allows the court to go beyond its
jurisdiction, which is to decide whether a reorganization proceeding may be beneficial for all
concerned, whatever the state of mind of the debtor.

Good faith, as a requirement for filing a petition under Chapter 11, has also been implied
under paragraph 362(d)(1), which allows the court to grant relief from the automatic stay of

66 House Report at 406, where it was said that the court "will be able to consider other factors as
they arise, and to use its equitable powers to reach an appropriate result in individual cases." See also
In re HBA East, Inc., 87 B.R. 248 at 258-259 (Bankr. E.D.N.Y. 1988); In re G-2 Realty Trust, 6 B.R.
549 (D. Mass. 1980), where the court dismissed an involuntary petition of three "friendly" creditors on
the basis that the debtor lacked good faith in changing its structure to make it eligible for Chapter 11
relief. A lack of good faith in filing the petition on the part of the debtor has been held to be an
equitable ground which would justify dismissal of the case [Phoenix Picadilly, supra note 49].

67 Code s. 105(a). See In re Hartford Run Apartments of Buford, Ltd., 102 B.R. 130 at 132

68 Flaccus, supra note 62 at 416.
proceedings, "for cause, including the lack of adequate protection of an interest in property . . ."69

The courts have granted creditors relief from the automatic stay of proceedings when it appears that
the debtor lacks good faith in filing the petition. Paragraph 362(d)(1) does not allow for the dismissal
of the case but it provides an effective means of enforcement of the concept of good faith,70 especially
in the case of a creditor holding security on all or a substantial portion of the assets of the debtor.

Unlike the United States, which has a rich history underlying the current statutory provisions,
Canada has little to draw upon with respect to the absence of the concept of good faith in the
legislative schemes being considered. As mentioned previously, the New Brunswick Court of Queen's
Bench refused to read an element of good faith into the provisions of the CCAA based on a plain
reading of the act.71 The court found, however, that the debtor was not acting in bad faith in creating
the instant trust deeds.

Although the New Brunswick Court of Queen's Bench rejected the argument that the debtor
must be acting in good faith in commencing proceedings under the CCAA, Canadian courts have since
implied a concept that appears to approach a notion of good faith. The approach taken by the courts
in this regard is similar to the approach taken by some courts in the United States when considering
whether a Chapter 11 case should be converted to a liquidation or dismissed on the basis that there is

69 See e.g., Victory, supra note 21 at 560; cf. In re Beach Club, supra note 49, where the court
found that the creditors were adequately protected. See also In re Lotus Investments, Inc., 16 B.R. 592
(Bankr. S.D. Fla. 1981) where the court said:

"While s. 362(d)(1) does not specifically incorporate s. 1112(b), it is reasonable to conclude
that a creditor should be granted relief from the stay if the case is one which the court should
dismiss if a motion to dismiss under s. 1112(b) were presented." [at 595]

Although this logic makes practical sense, the court, with respect, assumes that good faith is an
element of s. 1112(b) that justified conversion or dismissal. Neither section expressly so provides.
For a full discussion of section 362 of the Code, see chapter V(A), below.

70 E. Di Donato, "Good Faith Reorganization Petitions: The Back Door Lets the Stranger In"

71 United Maritime Fishermen, supra notes 38 and 39 at 54 (N.B.Q.B.).
an absence of a reasonable likelihood of rehabilitation under paragraph 1112(b)(1) of the Code.\textsuperscript{72}

Under the CCAA, a challenge to the debtor's ability to successfully rehabilitate itself is generally taken as a challenge to the stay of proceedings.\textsuperscript{73} If a creditor that holds security on all or substantially all of the property of the debtor succeeds in its challenge, the proceeding will be effectively dismissed, as the debtor will no longer have assets with which to attempt to reorganize. \textit{First Treasury Financial Inc. v. Congo Petroleums Inc}\textsuperscript{74} illustrates the approach. In that case, a secured creditor of the debtor brought an application for the appointment of a receiver and manager pursuant to its debenture. Secured creditors holding approximately 60 percent of the amount owing to all secured creditors and an unsecured creditor whose claim constituted "well over half of the unsecured claims" of the debtor supported the application.\textsuperscript{75} The debtor brought a cross-application for relief under the CCAA.

The court allowed the application of the secured creditor and dismissed the application of the debtor on several bases, including the fact that "any plan Congo could put forward would almost certainly be turned down by both the secured and the unsecured creditors."\textsuperscript{76} The court did not discuss the motives of the debtor in seeking relief under the provisions of the CCAA in terms of its good or

\textsuperscript{72} Paragraph 1112(b)(1) of the Code requires an additional element to be proved when a court dismisses or converts a case under that provision, viz., the "continuing loss to or diminution of the estate." Despite this additional requirement, some courts have considered the likelihood of a successful reorganization as a separate element and have dismissed or converted the case on that basis alone. See \textit{e.g.}, \textit{In re Canion}, 129 B.R. 465 (Bankr. S.D. Tex. 1989); \textit{In re Mogul}, 17 B.R. 680 (Bankr. M.D. Fla. 1982); \textit{In re Dutch Flat Investment Co.}, 6 B.R. 470 (Bankr. N.D. Cal. 1980); \textit{In re Pappas, supra} note 21 where the court applied both arms of the test. The diminution of the estate would result from the fact that the debtor had no equity in its assets and the debts would continue to increase as a result of accruing interest and taxes.

\textsuperscript{73} This issue will be fully discussed in Chapter V(A)(4)(a), below.


\textsuperscript{75} \textit{Ibid.} at 238. In order to succeed, a compromise or arrangement must be accepted by a majority in number, representing three-fourths in value of the creditors, or class of creditors, voting at the meeting directed by the court. [CCAA s. 6].

\textsuperscript{76} \textit{Ibid.} at 240 [emphasis added].
bad faith. However, one might infer from the reasons for the decision that the court may have been influenced by certain factors that pointed to the lack of *bona fides* of the debtor or its principals. The court observed that:

(a) the debtor had "deliberately qualified itself" to seek relief under the CCAA by issuing an "instant debenture" so as to bring itself within the requirements of section 3 of the CCAA;\(^7^7\)

(b) the family that controlled the debtor had "enhanced its own position vis-a-vis [the unsecured creditors] by taking security to the extent of $5 million . . . from the company to that value".\(^7^8\)

(c) the objective of any plan would not be to continue the business of the debtor but to sell it off in whole or in part and that a merchant banker retained by the debtor to assist the debtor with its financial difficulties "was concerned with the agenda" of the family that controlled the debtor;\(^7^9\) and

(d) "... Cango is simply asking the Court to stay the hands of creditors in the hope that, in whatever period of grace is granted, something more will happen than has occurred during the past 9 months, and that something will permit the company to be salvaged."\(^8^0\)

We must contrast the approach taken in *Cango* with the approach taken by the same court in *Re Perkins Holdings*.\(^8^1\) In that case, the court recognized that proceedings under the CCAA should be discontinued if the situation is "totally hopeless,"\(^8^2\) since the plan would have no hope of succeeding given the creditors' strong opposition to it. However, the court allowed the debtor's application under the CCAA on the basis, *inter alia*, that the debtor "recognized its financial problems and retained outside help in an attempt to resolve them."\(^8^3\) Again, the court did not allude to the motives of the debtor in seeking relief under the CCAA. However, the basis on which the court allowed the

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\(^7^7\) *Ibid.* at 235, 236.

\(^7^8\) *Ibid.* at 238.

\(^7^9\) *Ibid.* at 240.

\(^8^0\) *Ibid.* at 238.


\(^8^2\) *Ibid.* at 303.

\(^8^3\) *Ibid.* at 306.
application certainly points to the "state of mind" of the debtor.

Reported cases considering the BIA have not addressed the issue of good faith in commencing proposal proceedings. However, one commentator suggested that good faith may be an issue to be considered under subsection 50.4(11) in a motion by a trustee, interim receiver or a creditor for the termination of the period during which the debtor may file a proposal. This does not directly address the issue of whether the debtor must be acting in good faith in commencing proposal proceedings, as the issue is not considered at the outset of the case. It is considered as part of an application that is heard once the court has accepted jurisdiction of the matter.

An absence of a requirement or specific exclusion of good faith may prove to be beneficial for Canadian practitioners seeking to challenge the commencement of reorganization proceedings by a debtor on that ground. Unlike the Code, where it is at least arguable that good faith should not be an element to be considered as a filing requirement, given its specific exclusion, in Canada, the courts have the right to consider the concept under their equitable jurisdiction. Under the BIA, the courts listed in section 183 "are invested with such jurisdiction at law and in equity as will enable them to exercise original, auxiliary and ancillary jurisdiction in bankruptcy and in other proceedings authorized by this Act" [emphasis added]. The CCAA provides certain courts with jurisdiction to hear applications and make orders thereunder. The various courts listed in the CCAA, by their enabling provincial statutes, are invested with legal and equitable jurisdiction within their respective territorial jurisdictions. Accordingly, the various courts hearing applications under either the BIA or the CCAA

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84 K. Ham, "Corporate Restructuring Under Part III of the Bankruptcy and Insolvency Act" in Corporate Restructuring (Toronto: Canadian Institute, 1992) Tab III at 32. See chapter VI(B), below, for a general discussion on the time within which a plan proponent must file a plan.

85 Honsberger, supra note 42 at 23.

86 CCAA s. 2 "court".

87 See e.g., Judicature Act, R.S.A. 1980, c. J-1, s. 5(1)(a); Supreme Court Act, R.S.B.C. 1979, c. 397, s. 3, Law and Equity Act, R.S.B.C. 1979, c. 224, s. 4.
may apply the doctrine of good faith, apart the holding in *United Maritime Fishermen*. This is illustrated by the following quotation from a leading text on equity:

> These three maxims may be viewed as together illustrating that great distinctive and governing principle of equity, that nothing can call forth a court of equity into activity but conscience, good faith, and personal diligence.

Having established that the courts in Canada may have the jurisdiction to consider the "state of mind" of the debtor in commencing reorganization proceedings, we now turn our attention to whether the courts should consider good faith in determining whether to allow a debtor to commence or continue reorganization proceedings.

3. **Should Good Faith Be a Consideration?**

The commentators who suggest that there is or should be a good faith standard for commencing reorganization proceedings under the Code cite the legislative history and general principles of equity in support of that position. Conversely, those who argue that there is not or should not be such a standard cite the legislative history and the plain meaning of the statute in

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88 Supra note 38.

89 E.H.T. Snell, *The Principles of Equity* (London: Steven and Haynes, 1868) at 33. The three maxims referred to by the author are:

(a) He who seeks equity must do equity.

(b) He who comes into equity must come with clean hands.

(c) Equity aids the vigilant, not the indolent.

support of that position.91

It is difficult to argue that good faith should not be present when a debtor commences a reorganization proceeding. Said another way, should a business reorganization statute allow a debtor with improper or fraudulent motives the benefit of its protections? One's visceral reaction to such a proposition is to reject it outright. After all, it seems logical and proper that to take the benefit of a reorganization statute, the debtor should have an honesty of intent to use the legislation to attempt to reorganize.92 In addition, the good faith standard prevents the debtor from abusing the bankruptcy process for illegitimate or reprehensible purposes and maintains the jurisdictional integrity of the bankruptcy courts.93

While these arguments are compelling, the difficulty in requiring good faith as a precondition to allowing a reorganization proceeding to be commenced or continued is its abstract and intangible quality, as described in the definition set forth earlier.94 To be of assistance in the commercial environment, standards governing conduct must have predictability of result. Without such predictability, transaction costs will increase and forum shopping may result. One commentator expressed this concern over lack of predictability by noting that "the major problem with the good faith standard [is that] it is so vague that there will always be conflicting case law."95

91 See e.g., Flaccus, supra note 62; M.J. Bienenstock, Bankruptcy Reorganization (New York: Practising Law Institute, 1987) at 28-34; D.J. Tyukody, "Good Faith Inquiries Under the Bankruptcy Code: Treating the Symptom, Not the Cause" (1985) 52 U. Chi. L. Rev. 795; Di Donato, supra note 70.

92 Cohn, supra note 60 at 134.

93 Little Creek, supra note 49 at 1072.

94 Supra note 44 and accompanying text.

95 Flaccus, supra note 62 at 434-435; see also, Phoenix Picadilly, supra note 49, where the court said:

"... there is no particular test for determining whether a debtor has filed a petition in bad faith. Instead, the courts may consider any factors which evidence an intent to abuse the judicial process and the purposes of the reorganization provisions or, in particular, factors which evidence that the petition was filed to delay or frustrate the legitimate efforts of secured
While there may be reasons for attempting to determine the motives of the debtor in commencing the proceedings, there are adequate statutory protections afforded disgruntled parties, which may be invoked very early in the proceedings. A party may apply to have the automatic stay lifted under the Code for cause, including a lack of adequate protection. Under the BIA, the party may apply for relief from the stay if it determines that it is being materially prejudiced. In addition, the rules of court in the various jurisdictions in Canada provide that a proceeding that is frivolous or vexatious may be dismissed.

If the normative basis of a business reorganization proceeding is evident, the motives of the debtor should be irrelevant. That is, the court would merely be asked to consider whether the proceeding meets the objectives of the legislation. One writer suggested that dismissing a case based on bad faith may adversely affect creditors and the public interest by thwarting a reorganization and equitable distribution of the assets of the debtor based on the "mental sin of the debtor's proprietor or corporate officer." In other words, the courts should not focus on the "state of mind" of the debtor. They should consider the objectives of the legislation to determine whether reorganization will benefit creditors through an equitable distribution, whether there is a benefit to society as a whole by salvaging the business and having it continue as an ongoing entity and whether, through a reorganization, the debtor may be rehabilitated.

D. CONCLUSION

The character and motives of the debtor should not be considered by the courts in deciding creditors to enforce their rights." [at 1394, citations omitted].

96 See discussion in chapter V(A)(4)(c), below.

97 See e.g., Alberta Rules of Court, r. 129(1)(b).

98 Bienenstock, supra note 91 at 30-31.

99 cf. Phoenix Picadilly, supra note 49 at 1395 where the court said "[t]he possibility of a successful reorganization cannot transfer a bad faith filing into one undertaken in good faith."
whether to allow a reorganization proceeding to be commenced or to continue. The focus of the examination should be whether the proceeding will accomplish the objectives of the legislative scheme. Whether the debtor is insolvent, has issued bonds or debentures under a trust deed or is acting in good faith in commencing the proceeding should not be the focus of the court's inquiry. There are alternate means of suppressing an abuse of the bankruptcy process without compromising the interests of the parties to the proceeding. The court could, for example, lift the automatic stay of proceedings or dismiss the proceeding on the grounds that it is frivolous or vexatious. If there are legitimate reasons for maintaining the proceedings, irrespective of the character, conduct or motives of the debtor, the proceeding should be maintained.
CHAPTER IV

CUSTODY OF THE ESTATE OF THE DEBTOR

Reorganization proceedings commenced under the BIA require the intervention of a trustee, inter alia, to monitor and investigate the debtor's assets, business and financial affairs and to evaluate the cause of its financial difficulties. Section 47.1 of the BIA gives the court discretion to appoint an interim receiver, in addition to the trustee appointed under the proposal or named in the notice of intention to make a proposal. The court will appoint an interim receiver if it is considered necessary for the protection of the debtor's estate or the interests of one or more creditors or the creditors generally. Under the CCAA, although there is no express provision allowing for the appointment of a trustee or interim receiver, the orders promulgated at the outset of a proceeding under the CCAA "typically include provision for the appointment of a 'monitor'."

We must contrast this virtual automatic appointment of an independent entity having powers ranging from overseeing the debtor's operations and financial affairs to ousting its management, with the approach taken under the Code that maintains the debtor in possession of the business and its affairs. The ouster of the debtor's management by the appointment of a trustee under the Code has

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1 BIA ss. 50(2) and 50.4(1).

2 BIA ss. 50(5) and (10) and 50.4(7).

3 BIA s. 47.1(3).


5 Code s. 1101(1) defines "debtor in possession" as the "debtor except when a person that has qualified under section 322 of this title is serving as trustee in the case". In this chapter, the acronym DIP will be used to denote the debtor in possession.

6 Code s. 1104(a).
been described as an "extraordinary remedy" that will be allowed only on the basis of clear and convincing evidence. In other words, the debtor's right to remain in possession and control its financial and business affairs is a strong presumption.

This chapter will examine the concept of the DIP, its rights and duties and the checks and balances imposed by the Code and the courts which ensure that the DIP is fulfilling its duties. It will then examine the circumstances under and standards by which the courts determine whether the appointment of a trustee or an examiner is appropriate.

The purpose of this examination is to determine whether maintaining the DIP or, alternatively, whether the virtual automatic appointment of an independent third party is more likely to result in the fulfilment of the objectives of a business reorganization system. In so doing, this chapter will examine the advantages and disadvantages of appointing a trustee or examiner.

A. DEBTOR IN POSSESSION (DIP)

1. Legislative History and Conceptual Basis

The legislative history of the Code and the structure of Chapter 11 make it clear that the

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8 C.W. Frost, "Running the Asylum: Governance Problems in Bankruptcy Reorganizations" (1992) 34 Az. L. Rev. 89 at 121. See also Sharon Steel, ibid. at 1226 (3d Cir.), ibid. at 457 (Bankr.); Microwave, ibid. at 670.

9 Committee of Dalkon Shield Claimants v. A.H. Robins Co., 828 F.2d 239 (4th Cir. 1987) where the court affirmed the finding that the debtor was in civil contempt, but held that such finding was not to be equated with fraud or mismanagement sufficient to justify the appointment of a trustee [at 240].

10 Code s. 1104(b). The appointment of an examiner is a less drastic remedy. An examiner has investigative and reporting duties under paragraphs 1106(a)(3) and (4) but it does not have the same managerial and supervisory rights and duties as a trustee, such as the right to carry on the business of the debtor pursuant to section 1108 [D.W. Given, "When and Why Courts Appoint Trustees in Bankruptcy" (1988) 34:6 Prac. Law. 29 at 35].
debtor's prepetition management is to remain in possession and control of the debtor's financial and business affairs following commencement of the proceedings. Section 1107 provides that the DIP shall have all the rights and powers and shall perform all the duties of a trustee, other than certain obvious exceptions, such as the duty to investigate itself and report thereon. Section 1108 of the Code allows a trustee, unless the court orders otherwise, to operate the debtor's business. Thus, the DIP is entitled, *inter alia*, to carry on the debtor's business.\(^{11}\)

The concept of the DIP first appeared in section 77B.\(^{12}\) Chapter X retained the concept,\(^{13}\) but only with respect to entities that owed less than a prescribed amount. In all other cases, Chapter X required the appointment of an independent trustee.\(^{14}\) Chapter X included the requirement for the appointment of an independent trustee, in large cases, at the instance of the Securities and Exchange Commission,\(^{15}\) to protect public investors and the public interest. The trustee's role was not merely to investigate or supervise, but to take a very active role in the reorganization process. Besides investigative and supervisory powers, the trustee would supervise the negotiations leading to a reorganization plan, assist in the formulation of the plan and, ultimately, present the plan to the court.\(^{16}\)

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\(^{11}\) The legislative history reflects this intention. The House Report at 404, stated that section 1107 "places the debtor in possession in the shoes of a trustee in every way" and that section 1108 "does not presume that a trustee will be appointed to operate the business of the debtor. Rather, the power granted to trustee under this section is one of the powers that a debtor in possession acquires by virtue of proposed [section 1107]."

\(^{12}\) 77B(c)(1).

\(^{13}\) Chandler Act s. 156 provided, *inter alia*.

"Where the liquidated and non-contingent indebtedness of a debtor is $250,000 or over, the judge shall, upon the approval of the petition, appoint one or more disinterested trustees, who shall be qualified, except as to residence and location of office, as prescribed in section 45 of the Act. Where such indebtedness is less than $250,000, the judge may appoint one or more such trustees or may continue the debtor in possession."

\(^{14}\) Ibid.


\(^{16}\) R.J. McAfee, "Business Rehabilitation - Chapter 11" (1979) 48 U. Cin. L. Rev. 392 at 393.
Chapter XI provided, in substance, that the debtor was to remain in possession and authorized the debtor to operate the business, unless a trustee was appointed.\footnote{Chandler Act ss. 342 and 343 provide:}

"342. Where there is no receiver or trustee, the debtor shall continue in possession of his property and shall have the title and exercise the powers of a bankruptcy trustee, subject, however, to the control of the court and to the limitations, restrictions, terms and conditions which the court may, from time to time, prescribe.

343. The receiver or trustee or the debtor in possession, when authorized by the court and subject to its control, shall have the power to operate the debtor's business and manage its property during such limited or indefinite period as the court may, from time to time, fix, and shall report thereon to the court at such intervals as the court may designate."

This was very similar to the Code's provisions. This issue of the appointment of a trustee was the subject of a "substantial debate"\footnote{Frost, supra note 8 at 113. The extent and nature of the debate is discussed in R.J. Berdan and B.G. Arnold, "Displacing the Debtor in Possession: The Requisites for and Advantages of the Appointment of a Trustee in Chapter 11 Proceedings" (1984) 67 Marquette L. Rev. 457 at 460-469. Illustrative of the extent of the debate, the writers of the latter article noted "... very few issues dealt with by Congress in connection with the drafting of the Code produced a greater divergence of views than the standards for the appointment of trustees." [at 461].} prior to the Code's passage. The resulting legislation is a composite of the Senate and House versions.

Chapter X required the appointment of a trustee in cases involving large, widely-held companies. The Senate Report felt that it was necessary to differentiate between a case involving a public company and one involving a private company and sought to retain a requirement for appointment of a trustee in the case of public companies, whatever their size.\footnote{Senate Report at 9-11.} The Senate Report expressed the necessity of this protective mechanism as follows:

In a large public company, whose interests are diverse and complex, the most vulnerable today are public investors who own subordinated debt or equity securities. The bill, like chapter X, is designed to counteract the natural tendency of a debtor in distress to pacify large creditors, with whom the debtor would expect to do business, at the expense of small and scattered public investors.\footnote{Ibid at 10.}

In other words, a trustee would protect the interests of the subordinated debt holders and investors
whereas, it was the Senate's perception that a DIP would only be concerned with self-interest.

The House Report spurned the public versus private company distinction. The report specifically referred to the fact that the securities laws and the vigorous enforcement by the Securities and Exchange Commission provide sufficient public protection.21 The House Report felt that "[t]he public and the creditors will not necessarily be harmed if the debtor is continued in possession in a reorganization case."22 The court, in considering whether a trustee would be appointed, would consider all factors and determine, in each case, whether there is a need for a trustee.23

The major divergence between the recommendations of the House Report and the resulting Code provisions was in the method of selecting the trustee. The House Report recommended that the United States trustee24 make the appointment of the trustee, following consultation with the parties in interest and subject to approval of the court, which, in most cases, would be perfunctory.25 The Code rejected this notion and provided that the court appoint the trustee "on request of a party in interest or the United States trustee."26

The DIP is the prepetition management of the debtor and practically, there is no change in or


22 Ibid.

23 Ibid.

24 The United States trustee is a government official appointed the Attorney General, see 28 U.S.C. 581 (1988). In creating the office of the United States trustee, the House Report explained the duties of the office as follows:

"Some of the supervisory functions removed from the judge will be transferred to a new system of United States trustees who will act as bankruptcy watchdogs, overseeing the qualifications and appointments of private trustees in bankruptcy cases, supervising their performance, monitoring their fees, and serving as trustees in cases where a private trustee cannot be found to serve." [House Report at 4]

The United States trustee is not unlike the Superintendent of Bankruptcy in Canada. See BIA ss. 5 and 6.


26 Code s. 1104(a).
replacement of the personnel of preexisting management. However, conceptually, because the DIP has powers and assumes duties that, before the filing of the petition, the debtor did not have, the DIP does not appear to be one and the same as the debtor. This has resulted in some courts describing the DIP as a "new entity." The analysis of the DIP as a new entity is useful conceptually. It is difficult, for example, without such analysis, to understand how the law may sanction a breach of a valid contract. However, if one proceeds on the basis that the DIP is a different entity from the debtor and that the DIP is not a party to the contract, such analysis is more palatable.

The courts have not universally accepted the new entity concept, however. For example, the United States Supreme Court in National Labor Relations Board v. Bildisco and Bildisco, held that the debtor and the DIP were the same entity but that the Code conferred on the DIP certain powers

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28 The DIP, postpetition, has the power, for example, to recover preferences or fraudulent transfers pursuant to sections 547 and 548 of the Code, respectively or it may reject or assume and assign executory contracts or unexpired leases pursuant to section 365 of the Code. This latter power is discussed at chapter V(B), below. Prior to the filing of the petition, the debtor did not have these powers. Conversely, the DIP has additional duties such as the filing of lists, schedules and statements required by subsection 521(1).

29 See e.g., Re Baldwin United Corp., 43 B.R. 443 (Bankr. S.D. Oh. 1984) [hereinafter Baldwin]; Shopman's Local Union No. 455 v. Kevin Steel Products, Inc., 519 F.2d 698 (2d Cir. 1975) [hereinafter Kevin Steel], where the court said "[a] debtor-in-possession under chapter XI or under chapter X, a trustee under the latter chapter, or a trustee in a straight bankruptcy proceeding is not the same entity as the pre-bankruptcy company." [at 704, emphasis original].

30 See e.g., Kevin Steel, ibid. This type of analysis is also useful for determining the priority of claims. Sections 503 and 507 of the Code give a first priority to administrative expenses which are "the actual, necessary costs and expenses of preserving the estate." Second in priority are allowed unsecured claims. If the DIP incurred the expense, the claim would be given an administrative expense priority. On the other hand, if the expense was incurred by the debtor, it would merely be an unsecured claim. See Baldwin, ibid. See also Re Wil-Low Cafeterias, Inc., 35 F. Supp. 965 at 968 (S.D.N.Y. 1940).

31 See e.g. Cle-Ware Industries, Inc. v. Sokolsky, 493 F.2d 863 (6th Cir. 1974) where, in rejecting the notion of appointing separate counsel for the debtor and for the DIP, the court said "[t]he debtor and the debtor-in-possession is one and the same person, although 'wearing two hats.'" [at 870-871].

and duties that the prepetition debtor did not have. This type of analysis is in keeping with the notion that legislation, if it is clear and unambiguous, may effect an object that, at first blush, appears to be contrary to our notions of fair play. The Code is clear in providing the DIP the right, for example, to reject a valid and enforceable executory contract or unexpired lease in circumstances where the debtor could not do so. The United States Supreme Court merely interpreted the plain and unambiguous language of the Code without seeing the necessity of attempting to draw a conceptual distinction between the DIP and the debtor. One writer characterizes this distinction between the debtor and the DIP as nothing more than a distinction in roles. That is, the DIP exercises its duties and powers for the benefit of "diverse constituencies," including creditors and shareholders, whereas the debtor's duties are limited to benefitting the equity holders.

2. Fiduciary Duty of the DIP

Although the structure of the Code makes the duties of the DIP and the trustee coextensive, with certain exceptions, the following examination will focus on the DIP's fiduciary duty, as the trustee, usually, will not exercise its duties in a biased manner.

33 Ibid. at 528


35 Ibid. at 1323.


37 Code s. 1107.

The DIP has the duty to act as a fiduciary of the estate and the estate's creditors. The United States Supreme Court outlined this duty as follows:

[T]he willingness of courts to leave debtors in possession is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary duties of a trustee. This duty does not extend to the debtor itself or the debtor's principals unless the principals are also creditors. In acting in its fiduciary capacity, the DIP must maintain a level of impartiality and treat all parties fairly and equitably. In addition, it must exercise the care and skill that a reasonable person would exercise in similar circumstances and must avoid profiting at the expense of creditors and the debtor's shareholders.

With the fiduciary duty imposed on the DIP comes liability for its breach. Negligence in the performance of its fiduciary duty may result in liability of the estate or personal liability. However,

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39 House Report at 404; Senate Report at 116. See also In re Johns-Manville Corp., 52 B.R. 879 (Bankr. S.D.N.Y. 1985), where the court said:

"Thus, Manville's directors, in negotiating any plan of reorganization, and indeed for as long as Manville remains in Chapter 11, are required by the Code to act as fiduciaries of the estate. . . . Any directors would have to act not for the narrow interests of shareholders, but as fiduciaries of the estate." [at 885]

For an extensive discussion of the fiduciary duties of the DIP, see Kelch, supra note 34.

40 Commodity Futures Trading Commission v. Weintraub, 471 U.S. 343 at 355 (1985) [citations omitted], on remand 776 F.2d 1049 (7th Cir. 1986).


42 Kelch, supra note 34 at 1344. See also In re Cochise College Park, Inc., 703 F.2d 1339 (9th Cir. 1983) at 1357 [hereinafter Cochise College Park].

43 Cochise College Park, ibid.

44 Microwave, supra note 7, where the court held that "any attempt by the individual board members [of the DIP] to structure deals that would benefit them privately to the detriment of other creditors would contravene the fiduciary relationship." [at 672].

45 Ford Motor Credit Co. v. Weaver, 680 F.2d 451 at 461 (6th Cir. 1982) [hereinafter Weaver]. See also In re Johnson, 518 F.2d 246 at 251 (10th Cir. 1975), cert. denied (sub nom. Clark v. Johnson) 423 U.S. 893 (1975).
personal liability will certainly result from intentional violation of the fiduciary duty.\textsuperscript{47} As there are only finite resources available for distribution among the debtor's creditors, the DIP must make decisions concerning the allocation of those assets.\textsuperscript{48} Accordingly, what one party sees as a breach of the DIP's fiduciary duty, others may see as completely fair dealing. In clear cases of intentional wrongdoing, the DIP will be held strictly accountable.\textsuperscript{49} On the other hand, the courts will uphold decisions based on reasonable business judgment.\textsuperscript{50} The DIP must exercise caution in making such decisions and be able to justify the basis of its decision, from a practical and documentary point of view.

The DIP may be put in the unenviable position of having to make decisions detrimental to both the debtor and the prospects of reorganization in the interests of "impartiality," if to do otherwise may be seen as a breach of its fiduciary duty.

3. \textbf{External Control of the DIP}

Besides the appointment of a trustee\textsuperscript{51} or examiner\textsuperscript{52} and the imposition of disclosure

\begin{footnotesize}
\footnote{\textit{Mosser v. Darrow}, 341 U.S. 267 at 272, 274 (1951).}

\footnote{\textit{Weaver}, supra note 45; \textit{In re George Schumann Tire and Battery Co.}, 145 B.R. 104 at 108 (Bankr. M.D. Fla. 1992), which was a chapter 7 case. In that case a trustee was found to have intentionally breached court orders requiring the payment of surplus funds to the debtor. The court granted personal judgment against the trustee. See also \textit{In re Weber}, 99 B.R. 1001 (Bankr. D. Utah 1989), where the court "pierced the corporate veil" and held the sole shareholder and director of the DIP personally liable for a breach of fiduciary duty [at 1011].}

\footnote{\textit{Microwave}, supra note 7 at 671.}

\footnote{See \textit{e.g., In re Weber}, supra note 47 at 1013.}

\footnote{See \textit{e.g., In re Johns-Manville}, 60 B.R. 612 at 615-616 (Bankr S.D.N.Y. 1986). In this case, the court approved the DIP's retention of lobbyists to monitor and express the views of the debtor on all legislative and regulatory matters with respect to, \textit{inter alia}, asbestos compensation legislation on the basis that there was a "reasonable basis for its business decision."}

\footnote{Code s. 1104(a). See discussion \textit{infra} notes 61-75 and accompanying text.}

\footnote{Code s. 1104(b). See discussion \textit{infra} notes 76-79 and accompanying text.}
\end{footnotesize}
requirements, the Code provides mechanisms for overseeing the powers exercised by the DIP. The legislative history suggests that Congress, while recognizing that creditor control in bankruptcy cases could be beneficial and is "theoretically sound," also recognized that most creditors are simply not interested in pursuing the debtor or participating in the bankruptcy process. This seems logical whether one is examining a Canadian proceeding or an American one. To continue its pursuit of a debtor once the debtor commences bankruptcy proceedings, a creditor will incur expenses that may result in a judgment against a person from whom the creditor will not recover anything. Should the creditor choose to participate in the proceeding directly as either an inspector (in a Canadian bankruptcy proceeding) or as a member of a creditors' committee (in an American reorganization proceeding), there may be significant time commitments involved in attending meetings and instructing outside advisors. Not surprisingly, Congress observed that "[c]reditor control in bankruptcy cases is a myth." Congress diminished certain functions of the creditors' committee in an attempt to make the creditors' committee procedure less onerous on the participants. The creditors' committee may consult with the DIP, investigate the debtor's affairs, participate in the formulation of the plan and request the appointment of a trustee or examiner. In reality however, creditors are still reluctant to participate directly in monitoring the debtor's affairs.

Creditors' committees were appointed in only a minority of cases. They usually failed to obtain assistance from an attorney, accountant, or other person familiar with the reorganization

Reference has already been made to the filing of lists, schedules and statements under subsections 1106 and 521(1) of the Code [See discussion supra note 28]. Other examples of disclosure during the reorganization proceeding is the duty to disclose the identity and affiliations of individuals that the plan proposes to serve as directors or officers postconfirmation [Code s. 1129(a)(5)(A)(i)] and the compensation payable to trustees during the chapter 11 case [Code s. 326(a)].

House Report at 92.

Ibid.

Ibid.

House Report at 104.

Code s. 1103.
process. They seldom conducted investigations of the cause of business failure or provided serious opposition to any course the debtor chose to follow. In those cases where they did oppose the debtor, they were unsuccessful.\textsuperscript{59}

Thus, it appears that, with the level of creditor apathy in reorganization proceedings, creditors' committees do not provide an effective mode of controlling the debtor. The more powerful weapon in the arsenal of a creditor is the \textit{ad hoc} power to raise and be heard on any issue in a case under Chapter 11.\textsuperscript{60} Under subsection 1109(b), a party may raise issues that affect it directly, though it is not involved in the case in any general supervisory capacity. The court may also limit the powers of the DIP under subsection 1109(b), acting \textit{sua sponte}. Subsection 105(a) of the Code provides:

\begin{quote}
The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, \textit{sua sponte}, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.
\end{quote}

Under subsection 1107(a), the court may circumscribe the powers of the DIP. This right points to the broad power of the court to control the operation of the business and the transactions entered into by the debtor, as well as the entire procedure contemplated by Chapter 11. The court may exercise the powers on a transactional basis, such as through hearings for relief from the automatic stay of proceedings or the rejection or assumption of executory contracts or unexpired leases.

The foregoing illustrates some external controls imposed on a DIP. However, parties take less than full advantage of these controls because of creditor apathy, which may be the result of the perception that the system is working adequately or, conversely, that the system is a complete failure and participating in it is a waste of time and resources. This paper will not examine that issue but

\textsuperscript{59} L.M. LoPucki, "The Debtor in Full Control - Systems Failure Under Chapter 11 of the Bankruptcy Code?" (2d Install) (1983) 57 Am. Bankr. L.J. 247 at 272. Professor LoPucki's study is one of the few quantitative analyses conducted in the field of business reorganizations.

\textsuperscript{60} Code s. 1109(b). This right must be contrasted with the section 34 of the BIA which permits only the trustee to apply for directions and does not permit any other party to apply. Creditors are given very little recourse to the courts and only in limited circumstances, see e.g. the right under section 69.4 of the BIA to apply to the court for a declaration that the stay of proceedings no longer operates in respect of that creditor.
merely observes that creditor participation in Chapter 11 cases is minimal. Provided that creditors are adequately protected and their positions are not eroding during the pendency of the case, one wonders whether the mandatory appointment of an independent third party is necessary or advisable.

4. **Appointment of a Trustee or Examiner**

The appointment of a trustee is an extraordinary remedy that the courts use sparingly. One court stated that, absent fraud, a trustee should not displace the debtor. The practical reason for this reluctance is that the DIP is usually more experienced and more familiar with the debtor's business and operations than the trustee. As well, the decision has financial aspects, as a trustee will undoubtedly consume the debtor's scarce financial resources in its attempt to familiarize itself with the debtor's business and the operation of the business. While courts recognize that, in most reorganization cases, some mismanagement or imprudent decision-making has taken place, they are sceptical that a trustee is in any better position to manage a business, properly and prudently, with which it has little or no familiarity. Thus, as complexity of the debtor's business or industry increases, the applicant's onus becomes heavier and there is an increased likelihood of the application failing. Generally, the courts require the applicant to establish a clear and convincing case for the appointment of a trustee,

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61 *Supra* note 7 and accompanying text.


63 *In re Anchorage Boat Sales, Inc.*, 4 B.R. 635 at 644 (Bankr. E.D.N.Y. 1980), where the court felt it appropriate to conduct a cost-benefit analysis in order to determine whether the appointment of a trustee was appropriate in the circumstances; *Microwave*, *supra* note 7 at 676.

64 *In re Anchorage Boat Sales Inc.*, *ibid.* at 645; *In re Queen Kontaratos Lines, Ltd.*, 10 B.R. 609 (Bankr. D. Me. 1981), where the court observed that "[i]t is reasonable to expect that no [sic] every business decision of a reorganization debtor will reflect exemplary business acumen . . . it being the exceptional reorganization case that does not come into this court at least in part because of some imperfect managerial decisionmaking." [at 610].


66 *Supra* note 8 and accompanying text.
although the Code does not require such a standard.

Subsection 1104(a) sets out the standards governing the appointment of a trustee. It provides:

At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee -

(1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or

(2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

Although the courts draw a distinction between the "for cause" standard in paragraph 1104(a)(1) and the "best interests" standard in paragraph 1104(a)(2), a "cause" under paragraph (1) that would not justify the appointment of a trustee under that paragraph would likely be an element considered in an analysis under paragraph (2).

The causes listed in paragraph (1) are not exclusive but are merely illustrative of causes that may justify the appointment of a trustee, as Congress listed the factors as "included" in the description of "cause." Also, the applicant need not prove all of the factors listed in paragraph (1) to have a trustee appointed but the listed factors are alternatives. For example, incompetent management is not necessarily dishonest. Improper conduct by prepetition management involving fraud or breach of fiduciary duty will justify the appointment of a trustee. Cases involving prepetition negligence, incompetence or errors of judgment of management are less clear. The courts examine

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67 Berdan and Arnold, supra note 18 at 472.

68 Code s. 102(3) provides "includes' and 'including' are not limiting."


71 See e.g., In re Fiesta Homes of Georgia, Inc., 125 B.R. 321 at 325-326 (Bankr. S.D. Ga. 1990), where the court displaced the DIP because of the presence of a conflict of interest that could lead to a breach of fiduciary duty; In re McCorhill Publishing, Inc., 73 B.R. 1013 at 1017 (Bankr. S.D.N.Y.).
these cases on a case by case basis to decide whether the conduct or omission is sufficient to justify the appointment of a trustee. These types of cases require the applicant to show cause by clear and convincing evidence.

Paragraph 1104(a)(2) provides the second basis for the appointment of a trustee. In considering the "best interests" standard, the court balances the respective interests at stake and, in particular, it examines the advantages and disadvantages of appointing a trustee. The court will consider the following factors in such a case:

(a) the trustworthiness of the debtor;
(b) the debtor in possession's past and present performance and prospects for the debtor's rehabilitation;
(c) the confidence - or lack thereof - of the business community and of the creditors in present management; and
(d) the benefits derived by the appointment of a trustee, balanced against the cost of the appointment.

The court must consider the additional costs imposed on the estate by the trustee's appointment and the availability of a trustee that is capable and willing to act. However, at the heart of the inquiry is whether the DIP or a trustee will more likely facilitate a confirmed plan of arrangement expeditiously. For example, if the creditors refuse to deal with the DIP under any circumstances, the court may be justified in appointing a trustee.

The court or the parties may consider the appointment of an examiner under subsection 1104(b) if there are concerns regarding the DIP or the conduct of prepetition management that are not

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72 Sharon Steel, supra note 7 at 1226 (3d Cir).
73 Berdan and Arnold, supra note 18 at 472.
74 Ionosphere, supra note 7 at 168 [citations omitted].
The limited role of the examiner and its report has been described as follows:

His findings do not have binding effect on the court or parties of those of a special master, arbitrator or magistrate; nor do they have the evidentiary character of an opinion by a court expert . . . An Examiner performs the investigative duties of the trustee, and may perform other investigative duties as the Court directs, but he stands on a different legal footing than a trustee.78

The examiner's reduced role results in a corresponding reduction in the onus on the party seeking the appointment. All that appears necessary to justify the appointment of an examiner is an allegation and evidence of mismanagement.79

B. THE CANADIAN APPROACH

The Colter Committee Report recommended that in all cases where a secured creditor has not appointed a receiver, the debtor should appoint a trustee to act as interim receiver.80 The role of the

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76 Code s. 1104(b) provides:

If the court does not order the appointment of a trustee under this section, then at any time before the confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor, if-

1. such appointment is in the interests of creditors, any equity security holders, and other interests of the estate; or
2. the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000.

77 In re Boileau, 736 F.2d 503 at 506 (9th Cir. 1984); In re International Distribution Centers, Inc., 74 B.R. 221 at 224 (S.D.N.Y. 1987). One court held that it is proper to appoint an examiner for the express purpose of investigating the issue of whether a trustee should be appointed [In re Hamiel & Sons, Inc., 20 B.R. 830 (Bankr. S.D. Oh. 1982)].

78 Baldwin, supra note 29 at 316.

79 McAfee, supra note 16 at 397.

80 Colter Committee Report at 56.
trustee or interim receiver, as contemplated by the report, was similar to the role assigned to the proposal trustee under the BIA, as the trustee or interim receiver would have been required to review the books and records of the debtor and maintain control and account for the disposition of the debtor's property during the interim period. However, the Colter Committee Report went further and provided the court the discretion to grant additional powers to the trustee or interim receiver, including the right to take possession and sell all or part of the debtor's property or manage the debtor's business. The BIA gives the proposal trustee relatively noninvasive duties, such as to report on the reasonableness of the debtor's projected cash-flow statement, notify the creditors of the filing of the notice of intention to make a proposal, monitor and report on the debtor's business and affairs and advise on and participate in the preparation of the proposal.

The court may give an interim receiver appointed pursuant to section 47.1 more invasive powers. Subsection 47.1(2) gives the court very broad discretion in determining the powers that may be given to the interim receiver, including the powers to take control over the debtor's business or property and to "take such other action as the court considers advisable." Although case law under the BIA has yet to establish the contours of the role of an interim receiver, the legislative grant appears to contemplate a broad and potentially invasive role.

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81 Ibid.
82 Ibid. at 56-57.
83 BIA s. 50.4(2).
84 BIA s. 50.4(6).
85 BIA s. 50.4(7).
86 BIA s. 50.5.
87 One must be cautious in attempting to analogize the interim receiver's role on the filing of a petition for a receiving order (a liquidation proceeding). It has been held that the interim receiver, in those circumstances, is to take only conservatory measures to protect the debtor's estate and is not to divest the debtor of its property [Re Soren (1926), 7 C.B.R. 545 (Ont. S.C.); Re Stuart-Sutterby (1930), 12 C.B.R. 267 (Ont. C.A.)]. It should be noted however, that the BIA specifically states that, in such circumstances, "the interim receiver shall not unduly interfere with the debtor in the carrying
The recent case of *Re N.T.W. Management Group Ltd.* illustrates the separation of the roles of the proposal trustee and an interim receiver. In that case, the court appointed an interim receiver on the basis that the debtor, after filing the notice of intention to make a proposal, opened a new bank account and deposited funds into that account that were subject to a security interest. Rather than appointing a separate entity as the interim receiver, the court appointed the proposal trustee, to reduce costs. The court further held that the proposal trustee need not relinquish its duties as proposal trustee but thereafter, it must fulfil the duties of proposal trustee and also, comply with the court ordered duties of an interim receiver.

The BIA does not provide a list of persons who may apply for the appointment of an interim receiver. It has been suggested that the proposal trustee or any creditor or creditors may make the application. In such an application, the applicant has the onus of showing that the appointment of an interim receiver is necessary for the protection of the estate or the interests of one or more creditors or the creditors generally. The courts have held that they must act cautiously in considering whether to appoint an interim receiver. The reason for this cautious approach is their desire to avoid precipitous action that could not only prejudice the hopes of the debtor for its recovery, but also the interests of creditors. The applicant must adduce evidence of an actual danger of dissipation of assets; mere

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89 In *Dufferin-Custom Concrete v. Carling/Maplehurst Developments Inc.* (1993), 22 C.B.R. (3d) 67 (Ont. Gen Div.), the court held that the "crucial consideration" in the appointment of an interim receiver is "to reduce or control costs as much as possible."


91 BIA s. 47.1(3).

suspected or feared dissipation will not be sufficient.93

A monitor appointed in an order under the CCAA must assess and review the debtor's business
and affairs on an ongoing basis.94 The court has the discretion to grant powers in excess of these
duties. In *Canadian Imperial Bank of Commerce v. Quintette Coal Ltd.*,95 the court refused to expand
the role of the monitor to include the right to prepare, negotiate and file the plan with the court,
coordinate the approval process and call and chair all meetings. The court felt that the objectives of
the CCAA96 would be best accomplished through the limited role of the monitor, who would be
subject to the court's supervision.

C. FULFILMENT OF OBJECTIVES AND PROPOSALS FOR REFORM

Although the primary objective of a business reorganization proceeding is the confirmation of
a plan of reorganization, there will be a period between the commencement of the proceeding and
confirmation of the plan, during which many interim decisions and interlocutory proceedings will take
place. Those interim steps will affect the rights of the parties to the proceeding.

The appointment of an independent third party, in addition to or in substitution of former
management, will inject elements of objectivity and impartiality into the proceeding.97 This has the
advantage of easing the minds of the creditors, should there be a suspicion of wrongdoing or
negligence on the part of the former management of the debtor. The independent party will take an
objective look at the business operations to determine the most cost-effective manner of proceeding.

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94 Goldman, Baird and Weinczok *supra* note 4 at 199.


96 The court felt that the objectives are "to permit a corporation, through reorganization, to
continue its business and thereby prevent its organization from being disrupted and its goodwill lost." [*ibid.* at 260, emphasis added].

97 *Hotel Assocs.*, *supra* note 7. See also Berdan and Arnold, *supra* note 18 at 385-386.
henceforth, unencumbered by previous loyalties and relationships that may have clouded the judgment of former management. Following its review, the independent party may decide to liquidate or dispose of unproductive assets or divisions of the business and dismissal of long-term employees. More importantly, it can assess the financial viability of the debtor to determine whether a reorganization is a feasible alternative. The independent party will also undertake examinations and investigations that former management may be unwilling or unable to undertake, such as the review of insider transactions.

Conversely, the appointment of an independent third person will result in additional, often significant, costs that the creditors will bear. In addition, because the trustee or interim receiver may lack the experience of former management in the debtor's business operations and industry practices, there may be significant delay while the trustee or interim receiver familiarizes itself with these matters. This delay may result in loss to the debtor in terms of time, customers and suppliers. A more practical concern is that the independent person may not have the time or incentive to maintain the business in a way that will result in a confirmed plan of reorganization. This proposition has two aspects. First, the independent person may not have the necessary human resources to dedicate to the debtor's business. In times of severe macroeconomic difficulty, the independent person may be working at full capacity, with no personnel to dedicate to the debtor's affairs. Although this may result in a loss to the debtor's business, the more serious consequence is that the independent third person may view the most expeditious solution as the best solution in the circumstances, viz., liquidation. A related concern is the perception in the insolvency community that, if the third party can deal with and conclude the matter expeditiously, the appointing creditors may be more inclined to provide the trustee or monitor with replacement work. Although this is a valid consideration for the free-market mentality of the insolvency practitioners, it hardly encourages support of the debtor's


99 Ibid.
reorganization efforts.

In a broader sense, the virtual automatic appointment of a trustee or monitor may provide a disincentive for management to seek the protection of a reorganization statute, even if a reorganization is the most effective means of solving the debtor's problems.\footnote{House Report at 233-234; see also Frost, supra note 8 at 136.} Management may feel that a total or partial loss of control may spell the demise of the business because of the lack of knowledge of trustees and monitors and the costs resulting from their appointment. This type of approach defeats the purpose of a business reorganization regime, as it results in debtors waiting until the last possible moment before seeking the protection that may have saved them some months previously.

To fashion proposals for reform, it is necessary, in first instance, to determine whether the business community wants a business reorganization regime. If that inquiry leads to an affirmative response, we must determine the best method of accomplishing that objective. If we accept Professor LoPucki's observation that creditors take little active interest in the affairs of their debtors,\footnote{LoPucki, supra note 59 and accompanying text.} we must question the role of the independent person appointed to protect the creditor's interests.

The virtual automatic appointment of a proposal trustee to investigate the debtor's affairs or a monitor to supervise the debtor's business may not encourage a debtor to seek the protection of a business reorganization regime and may not serve the interests of all those concerned with the process, not the least of which are the creditors. Because the reorganization process is generally a "zero-sum"\footnote{Frost, supra note 8 at 119.} game, where there is a limited amount for distribution among the parties, with some parties gaining and others losing, the effective deployment of assets is of primary concern to the parties. The appointment of an independent third person will erode the resources available for the creditors and equity holders and accordingly, the decision to appoint an independent person to protect those interests should be left to the parties that will be paying for the benefit of that person's advice. Should the
parties have confidence in existing management or see no need in "throwing good money after bad," they should not be forced to pay for a resource that they do not want in the first place. Thus, in all cases, the presumption should be that the debtor remains in possession and control of the business and operations, but that the creditors be permitted to apply summarily to the court for the appointment of a trustee or monitor. The parties or the court, if the parties are unable to agree, will be determine the rights and duties of the trustee or monitor. In this manner, the stakeholders are making the decision concerning the disposition of "their" money.

In analyzing the creditors who are supporting the application, the court must be cognizant of the actual creditors that will bear the costs of the trustee or monitor. An undersecured creditor with security on all or substantially all of the debtor's assets will bear those costs, as any further expenditures will further erode its security. If the secured creditor is fully secured, the unsecured assets will bear the costs. In such a situation, the court must pay special attention to the interests of preferred and unsecured creditors.

If the policymakers put this type of system into place, sufficient checks and balances must exist for the courts and creditors to monitor and control the debtor's affairs. The debtor may see this as a small price to pay for the opportunity to attempt a reorganization. The legislation could implement provisions for adequate disclosure requirements, the possibility of having the reorganization proceeding converted to a liquidation, requirement for court approval and easy access to the courts by the DIP and other parties in interest for advice and direction.

These proposals do not derogate from the objective of a business reorganization system but enhance it. If the checks and balances and the debtor remaining in possession are satisfactory to the parties, there is no reason why the debtor should not remain in possession. The system should serve the constituents whose interests it seeks to protect. Providing flexibility to allow the parties to structure the proceeding in a way that serves their respective needs, while always providing the courts the opportunity to supervise the proceedings, attains this objective.
CHAPTER V
CERTAIN ADMINISTRATIVE POWERS

The title of Chapter 11 is "Reorganization" which may lead the reader to conclude that the focus of this paper would be on that chapter. However, chapters 1, 3 and 5\(^1\) are general provisions applicable to all proceedings under the Code. The "administrative powers" in subchapter IV of chapter 3 of the Code are the essence of a business reorganization proceeding, as those powers will determine whether the debtor will have an opportunity to attempt to formulate a plan of reorganization.

Subchapter IV of chapter 3 of the Code consists of six relatively short and, facially, simple sections. However, there is a very rich history underlying each section and they have each engendered a significant body of case law. This chapter will examine whether the administrative powers assist the American courts in defining and attaining the objectives of a business reorganization system.

The CCAA, through its loosely-worded provisions or through case law, has developed administrative powers similar to those outlined in subchapter IV of chapter 3 of the Code. This chapter will examine the development of those powers under the CCAA to determine whether they have enhanced or hindered the debtor in its reorganization efforts.

The BIA also has incorporated mechanisms similar to most of the administrative powers contained in the Code. However, the differences have a significant impact on whether the insolvent person will be able to put forth an acceptable proposal. This chapter will contrast the administrative powers contained in the Code with the mechanisms contained in the BIA to determine which system will better attain the objectives of the legislation.

This chapter will examine the concept of adequate protection and the automatic stay of proceedings that the Code imposes at the outset of a case. It will also review the discretionary stay of proceedings under the CCAA and the automatic stay of proceedings under the BIA and will consider

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\(^1\) They are, respectively, entitled "General Provisions", "Case Administration" and "Creditors, Debtor and Estate".
whether importation of the concept of adequate protection during the stay would assist a Canadian
debtor in its attempts to reorganize its financial affairs.

We will then examine of the issue of repudiation of real property leases. The Code and the
BIA specifically give the debtor the right to repudiate, reject or disclaim real property leases. In
certain circumstances, the courts allow debtors a similar right under the CCAA. Again, this chapter
will examine this power to determine which system fosters the objectives of the legislation.

The final section of this chapter will review the statutory schemes available to the debtor to
finance the proceeding and its operations during the proceeding. The Code has a comprehensive and
complex scheme for financing during the proceeding. Neither of the Canadian legislative schemes
appears to have addressed this specific issue, although out of necessity, creditors who allege material
prejudice to their interests by the absence of such provisions have raised the issue.

These issues have very practical and serious ramifications for the parties in interest. From the
debtor's perspective, a determination adverse to its interests on any of these issues may destroy the
possibility of its effecting a reorganization of its financial affairs. A creditor may find itself
financially unable to cope with the consequences of the exercise of an administrative power and may
face the possibility of its own insolvency.

A. ADEQUATE PROTECTION DURING THE STAY OF PROCEEDINGS

This section will examine certain changes to the rights and duties of secured creditors that
resulted from the passage of the BIA. In particular, this section will examine the stay of proceedings

2 The relationship between a debtor and its secured creditors and the validity and enforceability of
security are generally governed by law promulgated by the provinces pursuant to subsection 92(13) of
the Canadian constitution. That subsection delegates authority to the provincial legislatures to enact
legislation governing "property and civil rights in the provinces." However, when bankruptcy
intervenes, the federal bankruptcy and insolvency laws govern the relationships between the debtor and
its creditors and among the creditors. In the case of Cushing v. Dupuy (1880), 5 App. Cas. 409
(P.C.), the Judicial Committee of the Privy Council provided the rationale for this shift as follows:

"It would be impossible to advance a step in the construction of a scheme for the
administration of insolvent estates without interfering with and modifying some of the ordinary rights of property, and other civil rights, or without providing some mode of special procedure for vesting, realization, and distribution of the estate, and the settlement of the liabilities of the insolvent. . . . It is therefore to be presumed, indeed it is a necessary implication, that the Imperial Statute, in assigning to the Dominion Parliament the subjects of bankruptcy and insolvency, intended to confer on it legislative power to interfere with property, civil rights, and procedure within the Provinces, so far as a general law relating to those subjects might affect them." [at 416].

The courts in the United States have come to a similar conclusion. Chief Justice Fuller of the United State Supreme Court expressly recognized this right of Congress in Hanover National Bank of the City of New York v. Moyses, 186 U.S. 181 (1902):

"The subject of 'bankruptcies' includes the power to discharge the debtor from his contracts and legal liabilities, as well as to distribute his property. The grant to Congress involves the power to impair the obligation of contracts, and this the states were forbidden to do." [at 188].

Notwithstanding the right of Congress and the Parliament of Canada to abrogate the rights of secured creditors pursuant to their jurisdiction over bankruptcy and insolvency, the courts jealously guard the property rights of secured creditors. In the United States, constitutional challenges to federal bankruptcy laws take place primarily under the "due process" and the "unlawful taking" clauses of the Fifth Amendment. The relevant provisions of the Fifth Amendment provide that "[n]o person shall be . . . deprived of life, liberty or property, without due process of law; nor shall private property be taken for public use, without just compensation."

The concept of "due process of law," as that term is used in the Fifth Amendment, requires that a particular law not be unreasonable, arbitrary or capricious and that the law and its means of enforcement shall have a reasonable and substantial relation to the results being sought [U.S. v. Smith, 249 F.Supp 515 at 516 (S.D. Iowa 1966)]. Along with this general requirement, the courts require "substantive due process" and "procedural due process" in any case to which the Fifth Amendment applies. Substantive due process is the doctrine that a person shall not be deprived of life, liberty or property arbitrarily, and legislation that results in such deprivation must have a rational basis [Jeffries v. Turkey Run Consolidated School District, 492 F.2d 1 (7th Cir. 1974)]. Procedural due process, on the other hand, requires procedural fairness prior to depriving a person of life, liberty or property. At a minimum, the applicant must provide notification of the proceedings to the party being deprived, who must be given an opportunity to be heard at the proceeding. The proceeding must be held at a meaningful time and in a meaningful manner [Fuentes v. Shevin, Attorney-General of Florida, 407 U.S. 67 (1972)].

The 1935 United States Supreme Court decision in Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935) [hereinafter Radford] is seen by many commentators and courts as the decision that entrenched the Fifth Amendment principles into the bankruptcy power [See e.g., L.S. Jayson, ed., The Constitution of the United States of America - Analysis and Interpretation (Washington: United States Government Printing Office, 1973); In re Gifford, 669 F.2d 468 (7th Cir. 1982); U.S. v. Security Industrial Bank, 459 U.S. 70 (1982)]. The court in Radford was considering certain amendments to the 1898 U.S. Act that added provisions designed to save family-owned farms from foreclosure.

The court held the amendments to be unconstitutional as a violation of the principles contained in the Fifth Amendment and stated that "The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment." [Radford, supra at 589]. The court noted that despite
imposed on secured creditors at the outset of a reorganization proceeding and the protection afforded
to secured creditors as a result of the imposition of the stay of proceedings. The final part of this
section will consider the issue of whether stay provisions further the objectives of a business
reorganization proceeding.

The Colter Committee Report advised the policymakers that "[a]ny proposed change to our
bankruptcy legislation should be assessed in terms of how well it contributes to meeting the basic

the dire economic conditions and the importance of agriculture to the economy of the United States ".
. . private property shall not be thus taken even for a wholly public use without just
compensation."[Radford, supra at 602].

Radford uses the wording of the unconstitutional "taking" provision of the Fifth Amendment
and not the deprivation of life, liberty or property without due process of law. However, subsequent
decisions cite Radford as authority for the due process proposition [Wright v. Vinton Branch of the
Mountain Trust Bank of Roanoke, 300 U.S. 440 at 457 (1937)], as well as for the unconstitutional
taking proposition. Although there is some dispute among commentators and courts as to the nature of
the Radford decision, it is clear that both concepts have been applied and followed in subsequent
decisions [For a discussion of the debate, see In re Gifford, supra]. Thus, it can be said generally, that
the bankruptcy power is limited by the Fifth Amendment.

In Canada, there is a common law limitation on the legislative power to take property without
compensation. The lack of constitutional protection places the interests of secured creditors in
jeopardy should the Parliament of Canada choose to exercise its broad legislative powers to deprive
secured creditors of their interests in the bankrupt's property [J.M. Ferron, "The Constitutional
Impairment of the Rights of Secured Creditors in Canada and the United States" (1986), 60 C.B.R
(N.S.) 146].

To date however, the Anglo-Canadian courts have consistently held that, in the absence of a
clear intention to the contrary, legislation which takes private property or impairs a vested interest in
private property for public use or the use of third parties must provide compensation for that which is
taken. The courts have gone so far as to require not just reasonable compensation for the property
taken but full compensation [Belfast Corp. v. O.D. Cars Ltd., [1960] A.C. 490 (H.L.)]. The general
principle was recently applied in the case of Lloyds Bank Canada v. International Warranty Co.
(1990), 76 C.B.R. (N.S.) 54 (Alta. C.A.), leave to appeal to the Supreme Court of Canada refused
(1990), 76 C.B.R. (N.S.) xxix [hereinafter International Warranty]. In that case the Alberta Court of
Appeal held:

"For Revenue Canada to succeed, the plain and unambiguous meaning of the section must be
that it deprives a properly secured creditor . . . of all or part of its security without
compensation, for the purpose of paying another debt entirely unrelated to the security. It is
surely equivalent to the transfer of proprietary rights without compensation." [at 58]

Practically, the rights of secured creditors in Canada are similar to those of their
American counterparts, notwithstanding the lack of constitutional protection of property rights. This
functional similarity however, may be shattered by Parliament at any time by the utilization of "plain
and unambiguous" [International Warranty, supra] language.
goals or objectives of the law." Laws facilitating business reorganizations must attempt to strike a delicate balance between "the desire to achieve equity and fairness in the distribution of the bankrupt's funds" and assets, on the one hand, and the contractual rights of secured creditors, on the other hand. The Code and the CCAA tend to restrict the rights of secured creditors in a business reorganization proceeding to facilitate the object of achieving equity and fairness in the distribution of the assets comprising the estate and affording the debtor a fresh start. The former Canadian Act placed few restrictions on the rights of secured creditors. The Tassé Report recognized the significant increase in secured credit in Canada and the inadequacy of the former Canadian Act to adjust, efficiently and fairly, the relationship between debtors and creditors. It recommended changes to the legislation that would monitor and place certain restrictions on the rights of secured creditors. This chapter will consider whether the BIA is conceptually effective to resolve the inefficiencies and inadequacies perceived by the Tassé Report.

1. Terminology

(a) Secured Creditor

The Code does not define "secured creditor." Rather, it describes the claimant according to the nature of its allowed claim. Thus, whereas the 1898 U.S. Act referred to a creditor holding a security interest in the assets of the debtor as a "secured creditor," the Code now describes it as a "creditor secured by a lien on property in which the estate has an interest." That is, it classifies

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3 Colter Committee Report at 20.
6 Tassé Report at 62.
7 Code s. 506(a).
claims, not creditors, as secured or unsecured. The Code made this change to obviate the vagueness of the 1898 U.S. Act, where it was necessary to determine whether a creditor with a security interest in collateral of a value less than the amount secured was to be treated as a secured creditor or as a creditor that was partly secured and partly unsecured. Subsection 506(a) resolves this apparent problem by bifurcating the claim of the creditor into a secured portion and an unsecured portion. The claim is secured to the extent of the value of the collateral and is unsecured for the balance. This is a very important concept, as certain provisions of the Code define the interest or limit the claims of such creditors on basis of the amount of the secured claim and not by the full amount owed to the creditor.

As mentioned above, the creditor's claim is secured to the extent that the creditor has a "lien on property in which the estate has an interest." The Code provides a very broad definition of "lien," which includes inchoate liens. The Code then defines three categories of liens being judicial liens, security interests and statutory liens. This section shall concern itself only with liens created by way of security agreement and not with nonconsensual liens created by statute or judicial process. Liens created by way of

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8 See Barash v. Public Finance Corporation, 658 F.2d 504 (7th Cir. 1981); In re Glenn, 796 F.2d 1144 (9th Cir. 1986).

9 Bkr-L Ed, Code Commentary and Analysis s. 21:251. Under the Code, such a creditor is commonly known as an "undersecured creditor". The distinction between oversecured creditors and undersecured creditors is important for determining the extent of their entitlement to "adequate protection". See discussion, infra notes 49-77 and accompanying text.

10 See In re Glenn, supra note 8.

11 A plan of reorganization under Chapter 11 will be considered fair and equitable with respect to a class of creditors secured by liens on property in which the estate has an interest, only if the plan to provides, inter alia, that the claimants retain their liens on the collateral and that they receive deferred cash payments, each totalling the allowed amount of the secured claims and not the full amount of such creditors' claims [Code s. 1129(b)(2)(A), emphasis added].

12 Code s. 101(37) "lien" means charge against or interest in property to secure payment of a debt or performance of an obligation;

13 House Report at 312.

14 Code ss. 101(36), 101(51) and 101(52), respectively.
created by way of security agreement include real property mortgages and liens on personal property or fixtures created pursuant to appropriate state law.

Generally, nonbankruptcy state law determines the validity of the lien. However, even though valid under state law, the trustee or the debtor may avoid or subordinate the lien pursuant to the Code.

The BIA and the CCAA each define "secured creditor," but only the CCAA defines "unsecured creditor." Most of the case law considering these definitions involves determinations of whether a particular type of claim or interest makes the claimant a secured creditor. The vagueness of an in personam definition of the term has not yet caused any difficulty in practice. However, the BIA oscillates between references to secured creditors and "secured claims," which is an undefined term.

For example, subsection 50(1.2) of the BIA provides:

A proposal must be made to the creditors generally, either as a mass or separated into classes as provided in the proposal, and may also be made to secured creditors in respect of any class

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16 BIA s. 2:

"secured creditor" means a person holding a mortgage, hypothec, pledge, charge, lien or privilege on or against the property of the debtor or any part thereof as security for a debt due or accruing due to him from the debtor, or a person whose claim is based on, or secured by, a negotiable instrument held as collateral security and on which the debtor is only indirectly or secondarily liable;

CCAA s. 2:

"secured creditor" means a holder of a mortgage, hypothec, pledge, charge, lien or privilege on or against, or any assignment, cession or transfer of, all or any property of a debtor company as security for indebtedness of the debtor company, or a holder of any bond of a debtor company secured by a mortgage, hypothec, pledge, charge, lien or privilege on or against, or any assignment, cession or transfer of, or a trust in respect of, all or any property of the debtor company, whether the holder or beneficiary is resident or domiciled within or outside Canada, and a trustee under any trust deed or other instrument securing any of those bonds shall be deemed to be a secured creditor for all purposes of this Act except for the purpose of voting at a creditor's meeting in respect of any of those bonds;

"unsecured creditor" means any creditor of a company who is not a secured creditor, whether resident or domiciled within or outside Canada, and a trustee for the holders of any unsecured bonds issue under a trust deed or other instrument running in favour of the trustee shall be deemed to be an unsecured creditor for all purposes of this Act except for the purpose of voting at a creditors' meeting in respect of any of those bonds.
or classes of secured claim, subject to subsection (1.3). [Emphasis added]

This subsection, if read in isolation, exhibits the vagueness of the 1898 U.S. Act. As the BIA does not define "secured claim," we must assume that it is a claim by a person whose security has been proved and appropriately validated by the trustee. This subsection, furthermore, does not recognize the possibly bifurcated nature of a secured creditor's claim and specifically does not place the unsecured portion of the creditor's claim within the body of general creditors. These problems are, to a certain extent, addressed in subsection 50.1(3) of the BIA that states:

Where the proposed assessed value is less than the amount of the secured creditor's claim, the secured creditor may file with the trustee a proof of claim in the prescribed form, and may vote as an unsecured creditor on all questions relating to the proposal in respect of an amount equal to the difference between the amount of the claim and the proposed assessed value.

That subsection states that the secured creditor "may vote as an unsecured creditor," whereas the section prescribing the voting procedure specifies that "all unsecured claims constitute one class" and that the proposal will be accepted only if "all classes of unsecured creditors" vote for its acceptance.17

The BIA provides that the secured creditors may vote as unsecured creditors (the in personam description) for the shortfall amount but does not state that their shortfall claim would rank as an unsecured claim (the in rem description). Although one may argue that this is merely semantic discussion that has no practical consequence, in a proper case, it may prove to be problematic. For example, must unsecured creditors, simpliciter, or unsecured creditors and secured creditors voting as unsecured creditors accept the proposal?

This problem is magnified by the CCAA which neither sets forth the detailed procedure of the BIA nor provides specifically for the bifurcation of an undersecured creditor's claim. In fact, the decision in Re Northland Properties Ltd.18 questioned the notion of bifurcation under the CCAA, by holding that the same debt cannot give rise to separate classes.

Despite the foregoing discussion, "secured creditor," in this section, refers to a creditor having

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17 Emphasis, in both cases, added.

a valid security interest in an asset or assets of the debtor. This definition applies to references under the American or Canadian legislation.

(b) Adequate Protection

The Code does not define adequate protection although it refers to the concept in the sections describing an application for relief from an automatic stay, use, sale or lease of property of the estate when such property is subject to a lien in favour of a secured party and the obtaining of credit. We may garner an understanding of the concept from its objective, which is to ensure that the creditor receives "essentially what he bargained for" unless of course, receipt of that benefit frustrates or seriously interferes with the purposes of the Code's reorganization provisions. In the latter event, the creditors will receive the benefit of the bargain by alternate means.

Section 361 sets forth the three means of providing adequate protection as follows:

When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by -

(1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;

(2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease or grant results in a decrease in the value of such entity's interest in such property; or

(3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

19 Code s. 362(d).

20 Code s. 363(e).

21 Code s. 364(d).


23 Ibid.
These means are neither exclusive nor exhaustive.\textsuperscript{24} However, they are all intended to protect the creditor's interest in the property. With respect to secured creditors, the protection applies only to the "interest of an entity in property" and not to the amount of the debt or the value of the property, both of which may be more or less than the interest in the property.\textsuperscript{25} This appears to be reasonable. For example, in the absence of the stay, the secured creditor could recover only the amount of the debt or the value of the collateral, whichever is less.\textsuperscript{26} It follows then, that if the interest of the secured creditor has no value, there is nothing to protect.\textsuperscript{27}

The Fifth Amendment that protects a creditor from being deprived of its property without due process of law or just compensation\textsuperscript{28} is the source of the concept of adequate protection. Adequate protection seeks to address both of the issues raised by the Fifth Amendment. While acknowledging the constitutional basis of the concept, the legislative history indicates that public policy played a significant role in the development of the concept and the drafting of section 361.\textsuperscript{29} The constitutional basis protects the rights of the creditors. Public policy, on the other hand, focuses primarily on debtor rehabilitation or reorganization by the preservation of businesses and employment, the continuation of

\textsuperscript{24} House Report at 339.


\textsuperscript{26} As to whether a component of the secured creditor's bargain is compensation for lost opportunity cost has been the subject-matter of much debate. This topic will be examined \textit{infra} notes 49-77 and the accompanying text.

\textsuperscript{27} See \textit{e.g.}, \textit{In re 620 Church Street Building Corp.}, 299 U.S. 24 (1936), which held that, if a parcel of land on which there are a number of mortgages has an appraised value of less than the amount of the first mortgage, the subordinate mortgagees have no interest in that property which requires adequate protection.

\textsuperscript{28} \textit{Continental Illinois National Bank & Trust Co. v. Chicago, Rock Island & Pacific Railway Co.}, 294 U.S. 648 (1935); \textit{Radford, supra} note 2.

\textsuperscript{29} House Report at 339.
credit and the protection of investment. It also protects macroeconomic interests by preserving essential and viable industries. The concept of adequate protection requires the courts in the United States to attempt to balance those interests.

Negotiation and agreement on a method and procedure for providing adequate protection are the most economical ways of dealing with it. One writer suggested that the requirement of adequate protection should foster cooperation between the debtor and its creditors.

Once the creditor requests adequate protection of its interest, the onus is on the debtor or the trustee to propose a method of adequately protecting the creditor. The debtor will propose a method of adequate protection that will be acceptable to the creditor while minimizing the effect on its efforts to reorganize. If the secured creditor objects to the method of protection, the court determines the adequacy of the protection. The court will not, in the first instance, suggest the method of protection, as this would place the court in an administrative role.

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31 See e.g., Radford, supra note 2.

32 U.S. Bankruptcy Rules s. 4001(d) prescribes a procedure for the approval by the court of a settlement agreement between the debtor and its creditors concerning adequate protection. Although the U.S. Bankruptcy Rules do not mandate a priori approval, it has been held to be the preferred approach [ In re Blehm Land & Cattle Co., 859 F.2d 137 at 140 (10th Cir. 1988)]. Otherwise, the creditor is at risk that the court will refuse to sanction the agreement post facto, as being inequitable or contrary to the intent and purpose of the Code. U.S. Bankruptcy Rules s. 4001(d) seeks to preserve the due process rights of third party creditors who are entitled to notice of an application for approval of such an agreement.

33 A.N. Karlen, Adequate Protection Under the Bankruptcy Code, Its Role in Business Reorganizations" (1982) 2 Pace L. Rev. 1 at 33 where he states:

"Adequate protection may encourage a spirit of cooperation and negotiation between the debtor and its secured creditor, since it is to both party's advantage to confirm a plan to revitalize the debtor's business, and to provide adequate protection in the interim."


Subsection 361(1), allowing periodic cash payments, and subsection 361(2), allowing additional or replacement liens, compensate the creditor for the "decrease in the value of such entity's interest in such property" [emphasis added], not an interest in specific collateral. Consequently, if there will be no decrease in the value of the interest, there is no entitlement to adequate protection. For example, periodic cash payments may be appropriate to compensate for depreciation of property at a relatively fixed rate.36

Similarly, an additional or replacement lien protects the creditor's value in the original property, should it decline during the pendency of the case. The additional or replacement lien gives the secured creditor alternate or additional property upon which to realize the decreased value of the collateral.37

Most of the case law attempting to define the concept of adequate protection deals with the extent of the protection necessary to result in the creditor realizing the "indubitable equivalent" of its interest in the collateral. Congress borrowed the concept of "indubitable equivalent" from the frequently-quoted statement of Judge Learned Hand in *In re Murel Holding Corporation*38 where, in discussing the power given to a judge to provide a creditor with adequate protection, he stated:

> In construing so vague a grant, we are to remember not only the underlying purposes of the section, but the constitutional limitations to which it must conform. It is plain that "adequate protection" must be completely compensatory; and that payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a

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36 House Report at 339. See e.g., *In re Bemec Corporation*, 445 F.2d 369 (2d Cir. 1971), which originated the periodic cash payment method [Bkr-L Ed, Code Commentary and Analysis s. 15:5]. In that case, the debtor was in the business of leasing trucks and tractor-trailers. A number of secured creditors provided financing on security of the vehicles and opposed the reorganization petition. The court found that the secured creditors were adequately protected by the trustee's proposal to pay the "'economic depreciation' on the secured creditor's equipment so as approximately to preserve their status quo" [at 369].


38 75 F.2d 941 (2d Cir. 1935) [hereinafter *Murel*].
substitute of the most indubitable equivalence.\textsuperscript{39}

The legislative history indicates that the concept of indubitable equivalence was a general category intended to provide the courts with the necessary flexibility to fashion "new methods of financing."\textsuperscript{40} However, with a few exceptions, the protection awarded conforms to traditional methods of financing such as government mortgage guaranties,\textsuperscript{41} a combination of equity in the property, current payments and insurance coverage\textsuperscript{42} or curing defaults under a security agreement or lease and undertaking to meet payments as they fall due or providing the creditor with a security deposit.\textsuperscript{43}

More novel however, is the use by the courts of an "equity" or "value" cushion as adequate protection. As a secured creditor must be adequately protected for the value of its interest in the collateral and not for the amount of the debt, when the amount of the debt is greater than the value of its interest in the collateral, the secured creditor is "undersecured." The amount of the debt that exceeds the value of the secured creditor's interest in the collateral should not be adequately protected. The debtor, in other words, has no "equity" in the collateral.

Conversely, when the amount of the debt is less than the secured creditor's interest in the collateral, the secured creditor is "oversecured." Accordingly, the full value of its interest in the collateral should be adequately protected and the courts hold, in some cases, that the "equity cushion" provides sufficient adequate protection.\textsuperscript{44}

\footnotesize
\textsuperscript{39} Ibid. at 942.
\textsuperscript{40} Ibid.
\textsuperscript{42} Re Rose, 21 B.R. 272 (Bankr. D.C.N.J. 1982).
\textsuperscript{44} The first case to incorporate this concept was In re Blazon Flexible Flyer, Inc., 407 F.Supp. 861 (D.C.N.D. Ohio 1976) [hereinafter Blazon]. In that case, debtor owed the secured creditor approximately $1,340,000 for which it held security valued at $5,731,000. The secured creditor's concern was that by allowing the debtor to use the accounts receivable and inventory, which were valued in aggregate at $3,700,000, its Fifth Amendment rights were being violated. The court held
Several writers are critical of the evolution of the equity cushion concept where the "collateral cushion" is eroding through depreciation, accruing interest and costs, such as when the court holds the equity cushion in real estate to be adequate protection, without more. These writers do not dismiss the notion of an equity cushion as a component of adequate protection in a proper case, so long as the debtor provides the creditor with additional forms of adequate protection, such as periodic payments or replacement liens. One form of adequate protection that they suggest is

that in view of the value of the assets of the debtor and the amount owed to the secured creditor, the secured creditor's interests were adequately protected [at 864-865]. There were four factors that must be noted with respect to this case:

1. the amount owed to the secured creditor was approximately 23% of the value of the collateral;

2. there would be no detrimental effect on the security of the secured creditor as long as the accounts receivable and inventory were maintained at a level sufficiently in excess of the secured interest of the secured creditor;

3. the court ordered the debtor to provide financial reporting to it and to the secured creditor on a regular basis; and

4. the court allowed revision of its orders to be made on short notice in light of any changes in circumstance which would be detrimental to the secured creditor [ibid].

In other words, the court required, in addition to the equity cushion, regular reporting and maintenance of the equity cushion.


Flaschen, ibid, at 348 defines "collateral cushion" as the amount by which the value of the collateral exceeds the amount loaned by an asset-based lender.

McCafferty, note 45 at 33. See e.g. in re Mellor, 734 F.2d 1396 (9th Cir. 1984) where the court held that an equity cushion of approximately 20% was sufficient adequate protection. These types of cases prompted McCafferty to state:

"[the equity cushion as adequate protection] has now been applied to frustrate completely the rights of creditors secured by sluggishly illiquid real property in the hands of speculators, where the margins of value in excess of liens have been so narrowed as to make the Blazon financing arrangement look like the best loan Citicorp ever made!" [at 32].
providing the oversecured creditor with compensation for lost opportunity cost.\textsuperscript{48} Although such compensation usually concerns undersecured creditors,\textsuperscript{49} secured creditors that are provided adequate protection by the equity cushion alone, with no current interest being paid, will also seek that compensation.

Opportunity cost is defined as the loss incurred by a secured creditor by not being permitted to foreclose its lien, sell the collateral and reinvest the proceeds.\textsuperscript{50} Subsection 506(b) of the Code provides:

\begin{quote}
To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose. [Emphasis added]
\end{quote}

While subsection 506(b) allows an oversecured creditor to recover postpetition interest, fees and costs to the extent of the value of the collateral exceeding the amount of its secured claim, it still loses the time value of those amounts and thereby suffers a loss. An award of periodic payments to cover its opportunity cost\textsuperscript{51} would fully compensate the secured creditor in such circumstances. However, while it may be arguable that compensation for opportunity cost,\textsuperscript{52} should be awarded to an oversecured creditor, there is no statutory authority for awarding it to an undersecured creditor.\textsuperscript{53}

Compensation for opportunity cost has more importance to undersecured creditors. Unlike an oversecured creditor which may recover postpetition interest, fees and costs from the value of the

\textsuperscript{48} Flaschen, \textit{supra} note 45 at 353; McCafferty, \textit{supra} note 45 at 35.

\textsuperscript{49} Defined, \textit{supra} note 9 and accompanying text.

\textsuperscript{50} \textit{In re Timbers of Inwood Forest Associates Ltd.}, 793 F.2d 1380 at 1382 (5th Cir. 1986), aff'd 484 U.S. 365, 98 L Ed 740 [hereinafter Timbers, cited to L Ed].

\textsuperscript{51} Flaschen, \textit{supra} note 45 at 354.

\textsuperscript{52} A secured creditor would be well-advised to include a provision in its security agreement for lost opportunity cost to at least allow the argument to be made that such cost was contemplated by the agreement.

\textsuperscript{53} \textit{Timbers, supra} note 50.
collateral that exceeds its claim, the Code has no provision entitling an undersecured creditor to such amounts. Before the decision in *Timbers*, there was some uncertainty as to an undersecured creditor's entitlement to compensation for its opportunity cost.\(^{54}\)

To understand the uncertainty, we must refer to Judge Learned Hand's notion that adequate protection should be "completely compensatory" and that "payment ten years hence is not generally the equivalent of payment now."\(^{55}\) Many Bankruptcy and District Courts in the early 1980s held that the right of a secured creditor to repossess, sell and reinvest the proceeds is a valuable right worthy of protection and, following Judge Hand's opinion in *Murel*, awarded compensation for the present value of that right.\(^{56}\) In 1984, the court in *In re American Mariner Industries Inc.*\(^{57}\) upheld this position. The court held that the central issue in the case was not to determine how to provide adequate protection but whether\(^{58}\) the value of the collateral or the present value of the interest of the undersecured creditor in the collateral is an interest that must be protected. It was then necessary to determine the nature of that interest. While the court acknowledged that neither the legislative history nor the Code expressly mentioned protection of the secured creditor's right to foreclose, sell and reinvest the proceeds of sale of the collateral, it held that, "[u]nquestionably, however, these are valuable rights of secured creditors, and nothing in the reports suggests that they are not among those

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\(^{54}\) Immediately following the decision in *Timbers*, numerous law review articles praised the Supreme Court's decision as being strictly in accordance with statutory interpretation and provided undersecured creditors with strategies to assist them in coping or circumventing the *Timbers* decision. These articles pointed to the possible narrowness of the decision and criticized previous decisions that were contrary to the approach in the *Timbers* case as being ill-conceived. If the *Timbers* decision was so obviously correct, one wonders why there was any uncertainty in the first place.

\(^{55}\) See *supra* note 39 and accompanying text.


\(^{57}\) 734 F.2d 426 (9th Cir. 1984) [hereinafter *American Mariner*].

\(^{58}\) *Ibid.* at 430.
equitable and legal interests entitled to protection.\textsuperscript{59} The court therefore concluded that opportunity cost was an interest that required protection for the secured creditor to realize the benefit of its bargain.\textsuperscript{60} The court acknowledged that it was being "guided by equitable principles."\textsuperscript{61} It held that the award was consistent with Judge Hand's wording that Congress adopted in enacting section 361(3),\textsuperscript{62} which "at least encourages if not requires a present value analysis."\textsuperscript{63} The court acknowledged several times that it was standing on less than firm ground. However, from a pure public policy perspective, the decision is defensible.\textsuperscript{64} The policy underlying the decision is obvious from the following:

To the extent that the debtor in bankruptcy can prevent the secured creditor from enforcing its rights against collateral while the debtor benefits from the creditor's money, the debtor and his unsecured creditors receive a windfall at the expense of the secured creditor.\textsuperscript{65}

Meanwhile, Bankruptcy Courts in a number of other circuits concluded that neither \textit{Murel} nor

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{59} \textit{Ibid.} at 431.
\item\textsuperscript{60} House Report at 339.
\item\textsuperscript{61} \textit{American Mariner}, supra note 57 at 432.
\item\textsuperscript{62} \textit{Ibid.} at 434.
\item\textsuperscript{63} \textit{Ibid.} at 432.
\item\textsuperscript{64} See, \textit{infra} notes 69-76 and accompanying text.
\item\textsuperscript{65} \textit{American Mariner}, supra note 57 at 435. The Fourth Circuit Court of Appeals followed the \textit{American Mariner} reasoning in \textit{Grundy National Bank v. Tandem Mining Corporation}, 754 F.2d 1436 (4th Cir. 1985). The Eighth Circuit Court of Appeals in \textit{In re Briggs Transportation Co.}, 780 F.2d 1339 (8th Cir. 1985), also accepted that in an appropriate case, interest payments for the delay in foreclosing, liquidating and reinvesting the proceeds may be awarded but refused to "hold as a matter of law that a creditor is always entitled to 'such compensation' ." [at 1350]. The result of this case, while recognizing compensation for lost opportunity cost, was to require each court to examine on a case by case basis whether such interest is worthy of such protection. This approach would have resulted in considerable litigation and lack of predictability and accordingly, it was widely criticized. See e.g., Note, "Adequate Protection' and the Availability of Postpetition Interest to Undersecured Creditors in Bankruptcy" (1987) 100 Harv. L. Rev. 1106 at 1120.
\end{enumerate}
\end{footnotesize}
the Code intended to protect the foreclosure, liquidation and reinvestment interest and therefore refused to require compensation for loss of that "right." This position ultimately prevailed. In a carefully reasoned decision, Mr. Justice Scalia, who wrote for a unanimous court in *Timbers*, denied the undersecured creditor compensation for its opportunity cost. The decision is an exercise in statutory interpretation and is therefore of limited value for our purposes.\(^{67}\)

The court did not accept any of the equitable arguments put forth by the creditor. It is submitted that it could not accept those arguments as the Code, when read as a whole, presented the court with no ambiguity.\(^{68}\)

Given the care that Justice Scalia used in drafting his decision and his logical approach, it is difficult to challenge the soundness of the decision and the law review articles bear witness to that fact. However, the articles do not give credit to the soundness of the public policy concerns that *American Mariner* and subsequent decisions adopting that approach were attempting to address. In discussing an opinion that supported the public policy of *American Mariner* and was "notable for its misconceptions," one author wrote that the judge "... was apparently unaware or chose to ignore the fact that the bankruptcy laws are designed specifically to help debtors ..."\(^{69}\) Another author, referring to the fact that awarding compensation for opportunity cost would have adverse consequences

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\(^{66}\) See e.g., *In re Pine Lake Village Apartment Co.*, *supra* note 25; *In re Alyucan Interstate Corp.*, *supra* note 25; *In re South Village, Inc.* 25 B.R. 987 (Bankr. D. Utah 1982). As the conclusions reached by these courts accord with the decision of the United States Supreme Court in *Timbers*, a discussion of the reasoning in these cases will not be undertaken.

\(^{67}\) For example, the court held that section 506(b) allows postpetition interest to oversecured creditors only and not to undersecured creditors. As to oversecured creditors, they are only entitled to postpetition interest to the extent of the value of the collateral. Undersecured creditors as to the unsecured portions of their claims, must share the benefits and losses of a business reorganization with other unsecured creditors. They should not be given the benefit of interest on their secured claims before unsecured creditors receive any principal payments. Furthermore, section 502(b) of the Code prohibits the payment of unmatured interest.

\(^{68}\) *Timbers*, *supra* note 50.

on corporate reorganizations and would result in more liquidations said "accordingly, granting undersecured creditors lost opportunity costs would be poor public policy." 70

While decision in *Timbers* is sound, based on the wording of the Code, awarding compensation for opportunity cost is not necessarily poor public policy, for the reasons set forth by the court in *American Mariner.* 71 Bankruptcy law is not designed exclusively for debtors or unsecured creditors. It seeks to balance the interests of all parties in interest. Is it poor public policy to allow a secured creditor the benefit of its bargain, which is finite (i.e. a secured creditor can only recover, at most, its principal, interest and costs) while allowing the parties that have the most to gain from a reorganization and the least to lose from its failure, to use part of the assets upon which the secured creditor based its bargain? Several authors expressed the concern that *Timbers* would result in secured creditors requiring increased margins or alternatively, higher borrowing costs which could result in fewer out of court settlements and increased bankruptcies. 72 One wonders if this is sound public policy.

As the courts are moving away from fully compensatory adequate protection, several writers have suggested that creditors will be moving more quickly to seek relief from the automatic stay of proceedings and requiring the debtor to show that it has a reasonable possibility of successfully reorganizing within a reasonable time. 73 The result will be dismissal of the case or conversion to liquidation cases at an earlier stage in the proceedings. 74 It appears, therefore, that American


71 Supra note 57.


73 *Timbers*, supra note 50 at 751.

jurisprudence is moving toward the CCAA approach of questioning the feasibility of reorganization at the outset of the proceeding and forcing the court to look at the debtor's chances of success rather than the creditor's right to protection. Unfortunately, there have been few reported cases that test this hypothesis.75 As one writer noted, "[f]ew undersecured creditors waste time filing early motions for stay relief, and few bankruptcy courts are willing to write extensive opinions on a matter that has been clearly decided against the creditor's position."76

To avoid the risk of leaving the reader with the idea that the concept of adequate protection is illusory, it may be useful to summarize the concept. The court must grant adequate protection to a creditor on the creditor's request or when the Code requires it. Adequate protection protects the creditor from a decrease in the value of its collateral and it may assure the creditor that it will ultimately receive the value of its collateral at the dismissal or conclusion of the case. It also requires the debtor to maintain the property and not to expose the property to noncompensable loss through a lack of insurance. Finally, it is arguable that adequate protection would protect the "collateral cushion" or lending margin of an oversecured creditor.

However, it does not protect an undersecured creditor for its opportunity cost and, to that extent, it is not completely compensatory, as it deprives the undersecured creditor of the right to foreclose, sell and reinvest the proceeds, which is the "essence of secured lending."77

2. Nature of the Stay of Proceedings

The BIA and the Code impose an automatic stay of proceedings upon the commencement of

75 The reported cases to date merely confirm Timbers. See e.g., In re Reddington/Sunarrow Limited Partnership, 119 B.R. 809 (Bankr. D.N.M. 1990).

76 Shepard, supra note 69 at 43.

business reorganization proceedings. The BIA imposes the stay upon the filing of the notice of intention to file a proposal or the proposal itself. Under the Code, the filing of a petition under Chapter 11 results in the commencement of the stay. Unlike the BIA and the Code, a stay of proceedings under the CCAA is not automatic. It is a discretionary remedy granted by the court on application. In keeping with the philosophy that a business reorganization will be beneficial to all creditors, the CCAA allows "any person interested in the matter" to make the application, although usually it will be the debtor who seeks the stay. In considering whether to grant a stay of proceedings under the CCAA, the current trend is for the courts to examine the bona fides exhibited by the debtor and the feasibility of a successful reorganization, from the perspective of the creditors and from an economic perspective. The analysis conducted by the courts in these cases is not unlike the analysis conducted by United States courts when considering whether to grant a secured creditor relief from the automatic stay imposed by the Code.

The former Canadian Act contained no provision for automatically staying the rights of secured creditors upon the filing of a proposal. This severely restricted the use of the proposal provisions contained in the former Canadian Act. Until the revitalization of use of the CCAA in the early 1980s, this limitation resulted in there being no effective method under which to structure a business reorganization in Canada. The imposition of the automatic stay under the BIA is perhaps the most serious intrusion of the amendments into the rights of secured creditors.

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78 Code s. 362(a); BIA s. 69 and 69.1.


80 CCAA s. 11.


82 See discussion, chapter V(A)(4)(b), below.

83 BIA ss. 69(b) and 69.1(b).
The specific policies addressed by the stay of proceedings are common to the statutes being analyzed. However, the broader purposes of the legislation are reflected in the American version of the automatic stay, which seeks to attain the public policy objective of balancing the interests of debtors and creditors. This broader perspective requires the American courts to determine whether the stay is beneficial to all those concerned.

The Canadian courts, in considering the stay provisions of the CCAA, focus on the rights of the debtor only and the public policies involved in a reorganization proceeding, which usually results in the balance tipping in favour of the debtor. Furthermore, neither the CCAA nor the BIA contain the significant provisions of the Code that seek to protect creditors during the business reorganization proceeding. In the CCAA cases, this has led to an imposition of the stay with no provision for interim protection other than in some cases, the appointment of a monitor, or a complete dismissal of the case.

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84 Smaha, supra note 30 at 1116.


86 It is acknowledged that this generalized proposition does not take into account a number of other factors that the judiciary considers in an application by a secured creditor for relief from the stay. One such factor may be the relative shortness of time to complete a CCAA proceeding as compared to a Chapter 11 proceeding. However, in the case involving Quintette Coal Limited, the court granted the debtor a period of six months within which to effect a plan of arrangement. While the stay period may not appear inordinate, it must be remembered that the companies seeking relief from the stay were owed in excess of $36,000,000. It is submitted that a six month stay with no protection of the claims of the creditors could hardly be considered equitable from the creditors' point of view.

87 The Quebec Superior Court hinted at the possibility of "carving out" a secured creditor which considered its security to be in jeopardy. M. le juge Gervais in the case of Taché Construction Ltee. v. Banque Lloyds du Canada (1991), 5 C.B.R. (3d) 151 at 162, stated:

"L'intervenant n'a démontré à la Cour que ladite machinerie était plus en danger maintenant qu'auparavant et, tout comme les garanties de l'intervenante, la Banque Lloyds, celles de la Banque nationale du Canada doivent demeurer en suspens durant le moratoire."

[headnote translation, at 152:
"As for the creditor who held securities on the machinery, it did not establish that the machinery was now in greater danger than it had been before. Its securities, like that of the
The Colter Committee Report suggested a means of staying proceedings by secured creditors that recognized their need to be adequately protected while the debtor considered whether a reorganization was feasible. The recommendations allowed the secured creditor to collect accounts receivable, sell rapidly depreciating or perishable property, carry on the business of the debtor, solicit but not accept offers to purchase the collateral and take possession of but not remove property. In addition, the recommendations gave the courts a wide discretion to determine whether to lift the stay against the applicant secured creditor, based on whether the creditor was "adequately secured." Although the BIA incorporated the recommendation of imposing the stay against secured creditors, it gave secured creditors none of the rights, other than to apply to the court to seek relief from the stay on the grounds that the secured creditor is "materially prejudiced" or on other grounds.

Prior to the enactment of the Code, the policymakers recognized that the stay provisions under the 1898 U.S. Act and the rules promulgated thereunder were inadequate from the perspectives of the debtor, who required the protection of the stay, and the creditor against whom the stay applied and who needed relief from the stay when the collateral was deteriorating in value. The following frequently-cited excerpt from the House Report reflects the rationale and objectives of the automatic stay provisions of the Code:

> The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into principal creditor, should remain on hold during the moratorium.

Had the secured creditor been in a position to show that it was in greater danger, the court may have been willing to allow the creditor to have the stay lifted against it alone and allow it to realize on the machinery.

88 Colter Committee Report at 56.

89 Ibid. at 57.

90 BIA s. 69.4.

bankruptcy.

The automatic stay also provides creditor protection. Without it, certain creditors could pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally. A race of diligence by creditors for the debtor's assets prevents that.92

The foregoing policy statement reflects the culmination of the evolution of the concept of the stay of proceedings93 since the passage of section 77B.

Canadian courts, in describing the purpose of the stay provisions in the CCAA, use similar language. The courts describe the purpose as being to maintain the status quo for a period while the debtor attempts to gain the approval of its creditors for a proposed arrangement that will enable the debtor to remain in operation for the future benefit and well-being of the debtor and its creditors.94 The courts see the stay as a mechanism for "holding the creditors at bay"95 until the compromise or arrangement is approved by the court and the creditors or it is obvious that the attempt is "doomed to failure."96 For policy reasons that tend to favour the debtor, the courts are inclined to allow the debtor the opportunity to attempt a reorganization, even in circumstances where secured creditors have made it clear that they will not sanction a plan under any circumstances. The basis on which the courts hold that the stay should remain in place is that it is possible that the debtor could formulate some type of plan that would see the secured creditor paid out in full. The creditor would clearly accept this type

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93 See e.g., In re Maier Brewing Co., 38 F.Supp. 806 at 817 (S.D. Cal. 1941).


96 Ibid.
of plan. That is, the courts seem to grant the stay based on the "interest of the public in the continuation of the enterprise," such as by the number of people that the business employs or the nature or necessity of the commodities or services supplied by the enterprise.

This structure of the CCAA requires the courts to take this type of approach. The initial application under the CCAA must seek an order for a meeting of creditors, shareholders or both. It does not give any direction concerning the proceedings or substance of the meeting but we may assume that the purpose of the meeting is to consider the plan of compromise or arrangement. Section 11 allows the court to grant a stay of proceedings "whenever an application has been made under" the CCAA. The only application that the debtor can make is the initial application seeking an order for a meeting. In this manner, the court must consider some of the merits of the case when agreeing to grant the stay. Given the limited information provided to the court at that stage by the applicant, the fact that most initial applications are ex parte and faced with the general objectives of the CCAA, the courts seem to rely on the general policy and objectives of the CCAA in granting the stay. The courts have been reluctant to "carve out" certain creditors and allow them to realize on their security.

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99 Ibid. However, one case denied an application for a stay on the basis that the public did not have an interest in the continuation of the enterprise [Re Ursel Investments Ltd. (1991), 2 C.B.R. (3d) 260 at 279 (Sask. Q.B.), rev'd on other grounds (1992), 10 C.B.R. (3d) 61 (Sask. C.A.)]. This case appears to be an anomaly however, and is not indicative of the general trend.

100 CCAA ss. 4 and 5.

101 It is therefore more appropriate to discuss the exercise of the court's discretion in the context of a creditor seeking relief from the stay. See discussion, chapter V(A)(4)(b), below.

has resulted in applications to lift the stay entirely and to have the CCAA proceedings vacated. This approach clearly favours the debtor, as the only alternative to reorganization is liquidation, which is contrary to the intent of the legislation. This situation has prompted one writer to note, "[t]his creates a heavy onus on the creditor seeking to vary stay orders or oppose the reorganization and technical arguments are rarely likely to succeed in the face of 'economic reality' - the ends will invariably justify the means."\(^{103}\)

In the United States, on the other hand, the stay is automatic, which obviates the necessity of justifying the stay. The courts first face the issue of the necessity of the automatic stay on an application by a disgruntled creditor to have the stay lifted. The Code gives the court some direction concerning alternate remedies that it may grant on such an application. Specifically, the court may "carve out" a creditor's interest on proof of certain facts or may provide "adequate protection"\(^{104}\) to a creditor. As the court need not deprive the debtor of the opportunity to reorganize and as the secured creditor will be entitled to have its interest "adequately protected," the court balances the interests of the debtor and the secured creditor in determining whether to lift or continue the stay.

Adequate protection may take a number of forms.\(^{105}\) Canadian legislation does not give the courts authority to grant adequate protection and accordingly, they have simply denied secured creditors the ability to realize on their security, without providing any interim protection or compensation for loss during the stay period.\(^{106}\)

In summary, although the specific objectives of the stay of proceedings are common to all of

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104 Code s. 362(d)-(g).

105 See discussion, chapter V(A)(1)(b), below.

106 See *e.g.*, *Re Philip's Manufacturing Ltd.* (1992), 12 C.B.R. (3d) 133 at 138 (B.C.S.C.), where the court denied payment to a secured creditor of interest during the period of the stay as it would be "unfair" to "prefer" the bank as to interest when no other creditor will receive it.
the statutory schemes, the statutory schemes have determined, to a great extent, the way in which the stay will operate. The courts, in considering the CCAA, with its "all or nothing" approach to the stay look favourably at allowing the debtor the opportunity to reorganize. Unless the plan is "doomed to failure," the courts allow the debtor time within which to formulate the plan. The creditor has the onus of showing why the court should not grant the order.\(^{107}\) The courts in the United States, on the other hand, look at whether the creditor's interests are protected.\(^{108}\) Other than with respect to the issue as to whether the debtor has any equity in the property, the debtor has the burden of proof on all other issues.\(^{109}\)

Although the structure of the BIA allows the courts to consider relief from the stay on a creditor by creditor basis, the wording of section 69.4\(^{110}\) appears to place the burden of proof on the creditor seeking relief. That section provides:

A creditor who is affected by the operation of sections 69 and 69.3 may apply to the court for a declaration that those sections no longer operate in respect of that creditor, and the court may make such declaration, subject to any qualifications that the court considers proper, if it is satisfied

(a) that the creditor is likely to be materially prejudiced by the continued operation of those sections; or
(b) that is is equitable on other grounds to make such declaration.

With no statutory mechanism for providing secured creditors with interim protection, this section places a burdensome onus on the creditors. The courts, in considering cases under the CCAA, choose not to exercise their equitable jurisdiction to allow such interim relief or protection and, in fact, refuse to allow it.\(^{111}\) It is open to the courts, in considering cases under the BIA, to exercise their specific

\(^{107}\) *Bargain Harold's*, supra note 81 at 30.

\(^{108}\) Code s. 362(d).

\(^{109}\) Code s. 362(g).

\(^{110}\) BIA s. 69.4.

\(^{111}\) *Quintette*, supra note 102. See also *Re Alberta-Pacific Terminals Ltd.* (1991), 8 C.B.R. (3d) 99 (B.C.S.C.), where the court denied payments to a creditor pursuant to operating agreements notwithstanding continued use of the secured property by the debtor.
equitable jurisdiction\textsuperscript{112} and grant interim protection to secured creditors.

3. **Scope of the Stay of Proceedings**

Section 362(a) of the Code defines the scope of the automatic stay.\textsuperscript{113} The legislative history intended the scope of the stay to be broad and to encompass not only judicial proceedings, but also arbitration, license revocation and administrative proceedings against the debtor, as well as civil

\textsuperscript{112} BIA ss. 183(1) and (2); *Re Gold* (1927), 8 C.B.R. 39 (Ont. S.C.); *Re Heron* (1933), 15 C.B.R. 39 (Ont. S.C.).

\textsuperscript{113} Code, s. 362 (a):

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 USC 78eee(a)(3)), operates as a stay, applicable to all entities, of -

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.
actions and all proceedings even if they are not before governmental tribunals. The stay also enjoins a secured creditor holding a security interest under article 9 of the Uniform Commercial Code from repossessing its collateral by self-help or judicial process. To appreciate the extent of the stay, one only need review the definition of the term "entities," to which the automatic stay is applicable. An entity includes, inter alia, a governmental unit and a person, which in turn, is defined as including an individual, partnership and corporation. Although neither section 362(a) nor the definitions of "entity" or "person," refer to creditors and specifically, secured creditors, section 362(a) is clearly applicable to secured creditors. We should also note that a "claim against the debtor" includes a claim against the debtor's property and section 541 comprehensively defines "property of the estate."

The scope of the stay of proceedings that a court may order pursuant to section 11 of the CCAA is not as comprehensive as section 362(a) of the Code. Section 11 provides:

Notwithstanding anything in the Bankruptcy and Insolvency Act or the Winding-up Act, whenever an application has been made under this Act in respect of any company, the court, on the application of any person interested in the matter, may, on notice to any other person or without notice as it may see fit,

(a) make an order staying, until such time as the court may prescribe or until any further order, all proceedings taken or that might be taken in respect of the company under the Bankruptcy and Insolvency Act and the Winding-up Act or either of them;

(b) restrain further proceedings in any action, suit or proceeding against the company on such terms as the court sees fit; and

(c) make an order that no suit, action or other proceeding shall be proceeded with or commenced against the company except with the leave of the court and subject to such terms as the court imposes.

Should a court choose not to make a comprehensive order incorporating subsections (a), (b) and (c),


116 Code s. 101(15).

117 Code s. 101(41).

118 Code s. 102(2).
the extent of the stay will be limited accordingly. Two early CCAA cases serve to illustrate this proposition. In *Re Arthur Flint Company Limited*, the court considered a provision in an order that stayed all actions by unsecured creditors and a further order that stayed proceedings for the recovery of debts. The court held that proceedings under the former Canadian Act were not proceedings for the recovery of debts. In allowing a petition under the former Canadian Act to stand, the court noted that the stay order did not correspond to the wording of the CCAA that allowed the staying of proceedings under the former Canadian Act.

*Gray v. Wentworth Canning Company Limited* further illustrates the strict interpretation of a provision in a stay order. In that case, the court held that a provision in an order restraining proceedings that may "be taken" against the debtor prohibited only future actions, suits or proceedings against the debtor and that preexisting proceedings may continue. Because of *Arthur Flint* and *Wentworth Canning*, orders under the CCAA incorporate the language of section 11, enjoining the commencement or continuation of all present and future suits, actions and proceedings against the debtor, including proceedings under the BIA and the *Winding-up Act*. The courts have upheld these broad provisions.

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119 (1944), 25 C.B.R. 156 (Ont. S.C.) [hereinafter *Arthur Flint*].

120 (1950), 31 C.B.R. 182 (Man. K.B.) [hereinafter *Wentworth Canning*].

121 Ibid. at 185.

122 F.R. Foran and T.M. Warner, "Reorganizing the Insolvent Oil and Gas Corporation: The Courts and Fairness" (1990) 28 Alta. L. Rev. 132 at 143. See e.g., the stay order in the Quintette Coal Limited case which read as follows:

AND THIS COURT ORDERS that all proceedings taken or that might be taken in respect of the Petitioner under the Bankruptcy Act and the Winding-up Act or either of them be stayed;

AND THIS COURT ORDERS that any further proceeding in any action, suit or proceeding against the Petitioner be restrained;

AND THIS COURT ORDERS that no suit, action or other proceeding shall be proceeded with or commenced against the Petitioner;

The term "proceeding" determines the breadth of the stay. While it may be difficult to argue that an "action" or "suit" contemplates something other than a judicial proceeding, the term "proceeding" was the subject-matter of discussion in some of the earlier cases. The court in *Wentworth Canning*, gave the term a very narrow meaning. Using *ejusdem generis*, Kelly J. held that the word "suit" governs the word "proceeding" and accordingly, the stay enjoins only proceedings instituted in a court. Such a narrow interpretation would not prevent extra-judicial proceedings such as self-help remedies (where they are available under provincial law) or realizing on assigned or pledged property.

An early case that saw the revitalization of the CCAA rejected this narrow approach. In *Meridian*, Wachowich J. gave section 11 a wide interpretation to accommodate the purposes of the CCAA. Specifically, His Lordship refused to restrict the term "proceedings" to those involving a court or a court official. The courts have embraced this broad approach to abrogate the rights of secured creditors, for example, to foreclose on a real property mortgage, realize on security granted pursuant to section 427 (formerly section 178) of the *Bank Act* and notify third party lessees pursuant to an assignment of rents given to the secured creditor. The overriding principle, it seems, is that if realization on the security, regardless of its nature, prejudices the opportunity of the debtor to attempt a reorganization of its financial or business affairs, the court will enjoin the secured creditor from realizing on its security.

The stay provisions of the BIA are broad and appear to encompass most realization proceedings that a secured creditor could take. For example, subsection 69(1) provides:

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124 *Wentworth Canning*, supra note 120 at 185.
125 *Meridian*, supra note 94.
128 *Timber Lodge*, supra note 97.
Subject to subsections (2) and (3) and sections 69.4 and 69.5 on the filing of a notice of intention under section 50.4 by an insolvent person,

(a) no creditor has any remedy against the insolvent person or the insolvent person's property, or shall commence or continue any action, execution or other proceedings, for the recovery of a claim provable in bankruptcy,

(b) no provision of a security agreement between the insolvent person and a secured creditor that provides, in substance, that on

(i) the insolvent person's insolvency,
(ii) the default by the insolvent person of an obligation under the security agreement, or
(iii) the filing by the insolvent person of a notice of intention under section 50.4,

the insolvent person ceases to have such rights to use or deal with assets secured under the agreement as he would otherwise have, has any force or effect, and

(c) Her Majesty in right of Canada may not exercise her rights under subsection 224(1.2) of the Income Tax Act in respect of the insolvent person where the insolvent person is a tax debtor under that subsection, and Her Majesty in right of a province may not exercise her rights under provincial legislation substantially similar to that subsection in respect of the insolvent person where the insolvent person is a tax debtor under provincial legislation

until the filing of a proposal under subsection 62(1) in respect of the insolvent person or the bankruptcy of the insolvent person.

Paragraph (a) of the stay provisions imposes a stay against creditors that, by definition, includes secured creditors. The terminology appears, at first blush, to be straightforward and self-explanatory. However, on closer examination, the stay provisions of the BIA leave one with the feeling that the policymakers were unaware of the concerns raised in the cases under the CCAA. The terms "action" and "execution" should not be the subject-matter of debate. However, we again, must face the term "other proceedings." Although one would think that the courts will look to the decisions under the CCAA as a statute in pari materia to determine the scope of "other proceedings," Parliament could have clarified that term at the outset.

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129 BIA s. 2:

"creditor" means a person having a claim, preferred, secured or unsecured, provable as a claim under this Act;
In the event that the courts give "other proceedings" a broad interpretation, as under the CCAA, then the opening words of paragraph (a) may be superfluous, as the word "remedy," likely includes both judicial and self-help remedies. Should the courts give "other proceedings" a narrow interpretation, then the term "remedy" is limited to self-help remedies, and "other proceedings" contemplates a limited definition that cases as early as eight years prior to the BIA's enactment appear to have settled.

The stay of actions, executions or other proceedings in paragraph (a) concerns "the recovery of a claim provable in bankruptcy." A secured creditor may realize its security and prove the balance due after deducting the realized amount or, surrender the security to the trustee, and prove for the entire claim. Assuming, as often happens, that the secured creditor chooses to realize its security and prove for the balance, the stay provision arguably only stays the secured creditor with respect to the provable portion and not the secured portion. In that case, the first portion of paragraph (a) operates to enjoin the secured creditor from resorting to any remedy against the "insolvent person or the insolvent person's property." This would, logically, apply to a mortgagee under a real property mortgage or a secured party holding a security interest in the debtor's equipment. However, does it prevent a secured creditor from realizing on property that the debtor absolutely assigned to it or property in which the secured creditor has an interest that is tantamount to ownership? For example, a properly framed assignment of book debts conveys all of the right, title and interest in the book debts to the assignee such that the book debts "were never more the property of the assignor." In such a case, it is arguable that the secured creditor is not seeking a remedy against either the insolvent person or the insolvent person's property by requesting payment from the third party debtor. Similarly, security under section 427 of the Bank Act gives the bank the same rights and powers as if the

130 BIA s. 127.


132 Supra note 127.
bank had acquired a warehouse receipt or bill of lading in the secured property and consequently, all
the right and title to those documents and the goods, wares and merchandise secured thereby.\textsuperscript{133} It is
therefore arguable that the bank is realizing on what it already owns and it is seeking no remedy
against the insolvent person or the insolvent person's property.

While one may raise arguments to counter the foregoing positions, they illustrate problems that
the courts may face under the stay provisions. The policymakers could alleviate these arguments by
clarifying the stay provisions to address the concerns of secured creditors and debtors.

Paragraph (b) allows the debtor to "use or deal" with the collateral. From a secured creditor's
point of view, this provision may be more troubling than the actual stay of proceedings, as the BIA
provides no protection to the secured creditor for the debtor's use of "liquid" collateral such as
inventory or accounts receivable (assuming that the stay prevents the secured creditor from realizing
on those assets). A debtor could continue collecting accounts receivable or consuming inventory
without having to protect or compensate the secured creditor. While the secured creditor may apply
for relief from the stay, in such circumstances, such an application will force the courts to choose
between the interests of the secured creditor and those of the debtor or more broadly, the public policy
interests of allowing the debtor an opportunity to reorganize its affairs. The courts are placed in the
difficult position of determining the objectives of the legislation, with the wording of the BIA
providing little or no guidance.\textsuperscript{134} This provision is of even greater concern when one considers that
the BIA deems such provision in a security agreement to be of no "force or effect." This may provide
legislative sanction to the debtor diverting funds from the creditor that previously held security on
such funds, with no compensation being paid to such creditor. It is suggested that, in such a case, the
judiciary exercising its equitable jurisdiction, could inject the concept of adequate protection\textsuperscript{135} in

\textsuperscript{133} \textit{Ibid.} s. 435.

\textsuperscript{134} See discussion, chapter V(5), below.

\textsuperscript{135} See discussion, chapter V(A)(1)(b), below.
favour of a secured creditor without frustrating the business reorganization provisions of the BIA.

The foregoing shows that the courts, under the statutes being considered, have very broad powers to stay proceedings against the debtor. However, the inherent power of the court further augments these powers. Under the Code, the courts use subsection 105(a) to issue injunctions against parties or proceedings not otherwise stayed by subsection 362(a) or that subsection 362(b) specifically excepts from the scope of the stay. Subsection 105(a) of the Code provides:

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

In *In re Otero Mills, Inc.*, the creditor brought an action against the guarantor of obligations of Otero Mills, Inc. that was subject to protection under subsection 362(a) of the Code. The debtor asserted that the guarantor was going to contribute personal assets to it to effect the reorganization plan. The court, pursuant to subsection 105(a), prohibited the creditor from enforcing its judgment against the guarantor. Enforcement against the guarantor would affect the debtor's estate and adversely influence and pressure the debtor through the guarantor. The importance of this case lies in the formulation by the Bankruptcy Court of the test to determine whether the court would grant an injunction to enjoin a creditor from pursuing a co-debtor or guarantor. In such a case, the debtor must show:

1. irreparable harm to the debtor's estate if the injunction does not issue;
2. strong likelihood of a successful plan of reorganization; and
3. no harm or minimal harm to the other party or parties.

To this, the District Court added a fourth factor, which appeared to be the overriding and most influential factor. The court held that "in the bankruptcy setting, the public interest lies in promoting

136 25 B.R. 1018 (D.N.M. 1982) [hereinafter *Otero Mills*].


138 *Ibid.* at 1021, quoting the Bankruptcy Court.
successful reorganization." The court reinforced this factor by stating:

At the beginning of the reorganization process, a court must work with less evidence than might be desirable and should resolve issues in favour of reorganization. ... Although reorganization by any bankrupt may be speculative early in the proceedings, [the creditor] is protected in that if a reorganization plan is not approved, it may apply to the bankruptcy court to lift the injunction.

Subsequent case law and legal scholars have criticized the approach in *Otero Mills* as it "... would distort congressional purpose to hold that a third party solvent co-defendant should be shielded against his creditors by a device intended for the protection of the insolvent debtor and creditors thereof." Despite the criticism, other courts have followed it in different contexts. Therefore, the stay provisions may apply to the secured creditor even though the creditor seeks a remedy for which the stay provisions appear inapplicable.

The Canadian courts have recently begun explicitly recognizing their inherent jurisdiction in cases under the CCAA. The courts, however, do not require the increased burden of showing irreparable harm to the debtor's estate or a strong likelihood of a successful plan of reorganization. In

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142 *Lynch*, *ibid.* at 1197.

143 *E.g.*, *In re A.H. Robins Co., Inc.*, 828 F.2d 1023 at 1026 (4th Cir. 1987) [hereinafter *A.H. Robins*], where the court enjoined the plaintiffs from pursuing products liability insurers of the manufacturer of the Dalkon Shield on the grounds that such an action would require the insurer to involve the debtor and such involvement would cause irreparable harm to the bankruptcy estate by placing a burden on the officers, directors and employees of the debtor "which would exhaust their energies and thus interfere with the debtor's reorganization"; *In re Fussell*, 928 F.2d 712 (5th Cir. 1991), where the court held that it could enjoin state criminal proceedings premised on a debt owed by the debtor. But see *In re The Russell Corporation*, 156 B.R. 347 (Bankr. N.D. Ga. 1993), where the court held that the automatic stay "was not designed to benefit third parties, except to the extent that third parties benefit generally from the preservation of assets of the debtor." (at 349).

144 See *e.g.*, *Re Westar Mining Ltd.* (1992), 14 C.B.R. (3d) 88 (B.C.S.C.), where the court granted a "super-priority" to suppliers who were prepared to keep the debtor operating.
Campeau v. Olympia & York Ltd., the court exercised its inherent jurisdiction to restrain the plaintiff from continuing an action against a co-defendant of the debtor. Implicit in the decision is a recognition that section 11 of the CCAA did not provide the court with jurisdiction to restrain actions, suits or proceedings against entities other than the debtor company. Using language that echoes the reasoning in similar cases in the United States, the court stated, "... the restraining power extends as well to conduct which could seriously impair the debtor's ability to focus and concentrate its efforts on the business purpose of negotiating the compromise or arrangement." The court then makes the very curious statement that "[i]he balance of convenience must weigh significantly in favour of granting the stay, as a party's right to have access to the courts must not be lightly interfered with." The curiosity of this statement lies not in the proposition itself but the court's failure to justify interference with the plaintiff's right of access to the courts.

More recently, Mr. Justice Farley in Re Lehndorff General Partner Ltd., held that the court's inherent power to grant stays "can be used to supplement s. 11 of the CCAA when it is just and reasonable to do so." In this manner, His Lordship stayed proceedings, not only against the debtor companies but also against the individual interests of limited partners, as the business of the debtor companies was significantly intertwined with that of the limited partnerships.

Although the British Columbia Supreme Court, in the case involving Quintette Coal Limited enjoined creditors from demanding payment from the guarantors of the obligations of the debtor, it

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146 See e.g., A.H. Robins, supra note 43.

147 Campeau, supra note 145 at 309.

148 Ibid. at 309-310.


150 Ibid. at 38.

151 Ibid. at 35.
appears from the reported cases that that provision went unchallenged by the creditors. However, other courts refuse to stay actions against guarantors, directors and officers. In Philip's, the debtor obtained the stay by an ex parte application. The stay prevented creditors from taking proceedings against directors, officers, employees, agents or consultants of the debtor. The court refused to exercise its inherent jurisdiction to maintain the stay. It distinguished the American cases upholding such a stay on the basis that "there is a specific provision under the United States Bankruptcy Code, 11 U.S.C.S. (s. 105(a)), which empowers the court to issue 'any order . . . necessary or appropriate' to carry out the provisions of the Code." However, the court granted liberty to reapply in the event that the lack of the stay significantly interfered with the preparation of the reorganization plan.

The stay provisions under the BIA are limited to proceedings against the insolvent person or the insolvent person's property. As mentioned above, however, the BIA gives the courts equitable jurisdiction. In addition, the court has inherent jurisdiction with respect to all matters under the BIA. This gives the court a broad discretion to stay various actions that are in some way related to the insolvent person, the insolvent person's property or, more generally, the broad purposes of the

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153 Philip's, supra note 81.

154 Ibid. at 9.

155 Ibid.

156 See discussion, supra notes 110-112 and accompanying text.

157 In Re Loxtave Buildings of Canada Ltd. (1943), 25 C.B.R. 22 at 25 (Sask. K.B.), the court said:

"I realize that the bankruptcy law is statutory mainly and a Court should not go beyond the provisions of the statute applicable. But, if the subject-matter is within the statute, the Court may draw on its inherent powers to give effect to the provisions of the statute."
legislation. However, the stay of proceedings is in the nature of an injunction\textsuperscript{158} and governed by the same principles.\textsuperscript{159} In particular, the three factors cited in \textit{Otero Mills} reflect the general principles in a bankruptcy case\textsuperscript{160} and the public policy of promoting business reorganizations should not significantly influence the courts, unless all other factors are equal.\textsuperscript{161} The overriding consideration should not be the policy of encouraging business reorganizations but the very special and extraordinary nature of the exercise of inherent jurisdiction. As stated by the Supreme Court of Canada, "[i]nherent jurisdiction cannot, of course, be exercised so as to conflict with a statute or Rule. Moreover, because it is a special and extraordinary power, it should be exercised only sparingly and in a clear case."\textsuperscript{162}

4. \textbf{Lifting the Stay/ Dismissing the Case}

A challenge to the granting or continuation of the stay is "one of the major battlegrounds"\textsuperscript{163} of

\begin{itemize}
\item 1. a preliminary and tentative assessment of whether there is a serious question to be tried;
\item 2. whether the litigant who seeks the interlocutory injunction would, unless the injunction is granted, suffer irreparable harm, that is harm not susceptible or difficult to be compensated in damages; and
\item 3. a determination of which of the two parties will suffer the greater harm from the granting or refusal of the interlocutory injunction, pending a decision on the merits.
\end{itemize}


\textsuperscript{159} \textit{Ibid.} at 127-29, where Beetz J. set forth tests employed by the court in considering whether an injunction should be granted, being:

\begin{itemize}
\item 1. a preliminary and tentative assessment of whether there is a serious question to be tried;
\item 2. whether the litigant who seeks the interlocutory injunction would, unless the injunction is granted, suffer irreparable harm, that is harm not susceptible or difficult to be compensated in damages; and
\item 3. a determination of which of the two parties will suffer the greater harm from the granting or refusal of the interlocutory injunction, pending a decision on the merits.
\end{itemize}

\textsuperscript{160} \textit{Supra} note 138 and accompanying text.

\textsuperscript{161} \textit{MTS, supra} note 158 at 129-30. While the Supreme Court of Canada felt that the public interest should be a factor to be considered under its third test, it did so in the context of a challenge to the constitutionality of a statute promulgated by the Manitoba legislature. Although a business reorganization affects certain sectors of the public and the economy, it is suggested, with respect, that the Supreme Court of Canada was contemplating public rights in the context of laws which are passed "for the common good" [at 135]. The court then cites numerous examples, none of which appear to fall within the purview of what the court referred to as "the interests of private litigants" which in most cases, will be the types of interests sought to be protected under the inherent or equitable jurisdiction of the court under the BIA.

\textsuperscript{162} \textit{Baxter Student Housing Ltd. v. College Co-operative Ltd.}, [1976] 2 S.C.R. 475 at 480.

business reorganization proceedings. One American writer stated that "stay relief is the main event in many chapter 11 cases."

The difference in structure of the Code and the CCAA results in the parties seeking to challenge the stay taking different approaches. The courts in Canada focus on aspects of the case or stages in the proceeding that differ from their American counterparts. A strict comparative analysis of the approaches taken is difficult to conduct, although the approaches intersect periodically. This section will analyze each scheme separately and then, consider those schemes in light of the BIA.

Before embarking on the analysis however, we must address two matters. First, we cannot overstate the importance of the concept of adequate protection in an American proceeding. The theory underlying American stay litigation is that, so long as the secured creditor is provided with adequate protection or has an opportunity to repossess the collateral, there is no need for that creditor to question the right of the debtor to attempt to reorganize. The reorganization process is not harming the creditor. In this way, the debtor may continue operating the business while formulating a plan.

Conversely, the Canadian courts have not used the concept of adequate protection in dealing with cases under the CCAA. Accordingly, secured creditors have no alternative but to challenge the entire proceeding based on the lack of bona fides of the debtor or the feasibility of a successful reorganization. The burden placed on a secured creditor in taking such an approach is very heavy, given the inclination of the courts to afford the debtor an opportunity of exploring the reorganization alternative. In other words, the courts must choose between the secured creditor, whose interests are compromised, or the debtor, which is seeking to reorganize its affairs. Without the concept of adequate protection, there is no mechanism for the courts to use to strike a compromise; one party wins, the other loses.

A second matter that we must note is that, throughout the discussion that follows, passing

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reference will be made to the conduct of the parties. Although, generally, the courts do not expressly state that their decisions are heavily influenced by the conduct of the parties, such conduct appears to have some influence. One writer noted:

... while economic or financial factors are significant in automatic-stay litigation, these factors are not the only consideration that courts apply. Instead, litigation by creditors to lift the stay is often reached in light of the creditor's and debtor's behavior before and during the bankruptcy case. The result is a general balancing of equitable factors, especially in business cases, that is significantly more complex than the pure economic evaluation often suggested in the literature.165

With the limited number of cases under the CCAA, the fact that few cases specifically refer to the conduct of the parties and, most importantly, the fact that this aspect of the decision-making process is generally covert, it is difficult to garner any general principles from the decisions. However, the reader must be cognizant of this factor when reviewing the following.

(a) CCAA

A challenge to the stay generally takes place at the initial hearing, if the debtor applies on notice to other parties, or soon after the creditors receive or become aware of the stay order, if the debtor's application was ex parte. As the court is reluctant to carve out certain creditors, it is forced to consider the viability of the plan at a very early stage of the proceedings.166

In the event that a single-class creditor or a group of creditors of a class sufficient to defeat the compromise or arrangement advises the court that no compromise or arrangement will be acceptable,167 the court must face the issue of whether the compromise or arrangement is doomed to


166 The issue concerning the dismissal of a proceeding based on the inability of the debtor to secure the requisite statutory majorities is more appropriately discussed in the context of the creditors' voting on the plan. See discussion chapter VI(C), below. However, as the challenge to the stay puts the entire proceeding into question, there will necessarily be some overlap in the discussions.

167 In order to succeed, a compromise or arrangement must be accepted by a majority in number, representing three-fourths in value of the creditors, or class of creditors, voting at the meeting directed by the court [CCAA s. 6]. There is no provision in the CCAA which allows the court to "cram down"
failure. In such a case, the court will dismiss the application for the stay of proceedings or lift the stay, if the court granted the stay order on the \textit{ex parte} application of the debtor. The Ontario Court of Appeal faced this issue \textit{Elan}.\footnote{168} The majority of the court held that the appellant bank should be placed in its own class and, as that class would reject a plan of arrangement, the plan could not succeed.\footnote{169} As a result, the court lifted the stay of proceedings and dismissed the proceeding. In \textit{Diemaster Tool Inc. v. Skvotsoff (Trustee of)},\footnote{170} the court reached a similar conclusion despite testimony that the plan of compromise and arrangement would result in payment in full to the secured creditor.\footnote{171}

\begin{quote}
the plan on a \textit{class} of creditors that has rejected the plan as contemplated by section 1129 (b) of the Code. A rejection of the plan by a class of creditors merely results in a failure of the plan with respect to the rejecting class or, if a plan so provides, a failure of the plan in its entirety [CCAAs. 6; J.D. Honsberger, \textit{Debt Restructuring} (Toronto: Canada Law Book, 1993) at 9-40].
\end{quote}

\footnote{168} \textit{Elan}, supra note 97.

\footnote{169} \textit{Ibid} at 115. In reviewing the decision of the majority, one wonders whether the erosion of the collateral was the major factor being considered by the court, i.e. the lack of adequate protection. One of the primary securities held by the appellant was a first registered charge on accounts receivable. The court specifically referred to a previous order in the proceedings which stayed the appellant bank from acting on its security and allowing the debtor to spend up to $321,000 from accounts receivable collected by it [at 109].


\footnote{171} The debtor required the stay period to seek new debt or equity financing. The court appeared concerned with the fact that the debtor had been in financial difficulty and had been seeking debt or equity financing for almost two years prior to the application under the CCAA. Although not expressed, it appears that the court had little confidence in the debtor finding sufficient debt or equity financing to pay the secured creditor in full. This conclusion is implicit in the following statement:

\begin{quote}
"The bank would hardly vote for a result that would go against its own interests. Since it opposes any proposals or arrangements now, the bank would be expected to vote against it, thereby assuring rejection of any proposal by that class of secured creditor." [at 149]
\end{quote}


\begin{quote}
"In the present case, Cango is simply asking the Court to stay the hands of creditors in the hope that, in whatever period of grace is granted, something more will happen than has occurred in the past 9 months, and that that something will permit the company to be salvaged."
\end{quote}
The Ontario Court of Justice refined the test more recently in *Bargain Harold*s. While accepting the general proposition that the court will refuse an application for a stay if it is clear that no plan will be acceptable to the required percentages of creditors, the court held that the advice of certain secured creditors that they would not approve any plan put forth by the debtor does not put an end to the inquiry. The court felt that it must consider "all affected constituencies" including secured, preferred and unsecured creditors, shareholders, landlords, employees and the public generally. The court ultimately held that there was no reasonable prospect that the debtor could devise a plan that would satisfy those voting constituencies under section 6 and therefore, refused to impose the stay.\(^{174}\)

We must distinguish the foregoing cases from the cases that allow the debtor an opportunity to reorganize in the face of advice that a single-class secured creditor or a sufficient majority of a class will reject any plan put forth by the debtor. All of the cases, save one, emanate from jurisdictions outside Ontario. The British Columbia Court of Appeal in *Philips*\(^{175}\) and the Alberta Court of Queen's

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\(^{172}\) *Bargain Harold*s, supra note 81.

\(^{173}\) Ibid. at 30.

\(^{174}\) Ibid. at 32. This case is a clear example of the court's concern with the conduct of the debtor. Austin J. referred to a number of "important elements" which were used in reaching the decision, including:

1. the debtor did not know the precise nature of the problem which resulted in its financial difficulties and that its auditors advised that the cause may never be known;
2. the debtor had no idea how to salvage the operation, other than to "downsize";
3. the debtor lacked operating capital and certain shareholders who were in a position to assist in refinancing had made no offer to so assist;
4. the debtor failed or abandoned an attempt to raise equity to finance expansion on the basis of its financial and accounting problems; and
5. the debtor's admissions of mismanagement, with no proposed solution.

*Cf. Re Perkins* (1991), 6 C.B.R. (3d) 299 (Ont. Gen. Div.) [hereinafter *Perkins*], where the court distinguished *Cango*, supra note 171, on the basis of the conduct of the debtor and the support of the unsecured creditors, the latter of which was absent in *Cango*. In *Perkins*, the debtor itself "had recognized its financial problems and had retained outside help in an attempt to resolve it [sic]" [at 306].

\(^{175}\) *Philips*, supra note 81.
Bench in *Icor*\(^{176}\) imposed a stay of proceedings to allow the debtor an opportunity to negotiate and formulate a plan of reorganization and compromise. Each court further held that advice concerning the unequivocal rejection of any plan at any stage of the proceedings was not a sufficient basis upon which to dismiss the case, as the plan could result in full payment of the objecting creditor's claims or some other satisfactory arrangement.\(^{177}\)

Similar considerations appeared to have influenced the Prince Edward Island Supreme Court in *Timber Lodge*.\(^{178}\) The value in this case goes beyond the affirmation of those approaches, as the court suggested that there was evidence tendered which not only showed the objecting creditors to be "adequately protected"\(^{179}\) but also intimates that the creditors may be able to recover compensation for opportunity cost.\(^{180}\)

The foregoing illustrates the difficulties faced by the courts in analyzing the use or continued

\(^{176}\) *Icor*, *supra* note 97.

\(^{177}\) The Alberta case is interesting, as the court briefly discusses the financial position of one of the creditors. Although the terminology used by the court does not make clear whether it was using an appraised value of the collateral or the face value of the security, it is clear that the court felt that the creditor was "adequately secured"\(^{[at 164]}\). The debt was $2.2 million, the accounts receivable $1.4 million and the creditor held "debenture security of 1.5 million dollars." The creditor was complaining that the accounts receivable were being used for continuing operations to which the court replied "It is likely however, that the use of some of accounts receivable for ongoing operations will ultimately impinge upon unsecured creditors, rather than the [complaining creditor]." This indicates that the debenture security together with some of the accounts receivable would pay out the complaining creditor. The balance of the accounts receivable would be distributed among the unsecured creditors.

\(^{178}\) *Timber Lodge*, *supra* note 97.

\(^{179}\) *Ibid. at 252, 253*, where the court stated:

"... so long as the position of the rejecting respondents is not being unduly jeopardized, there should be an opportunity for the applicant to be put back on a firm foundation.

... I do not find that the debt of the objecting creditors will be compromised in the short term or that I would be necessarily delaying the inevitable if the application were granted."

\(^{180}\) *Ibid. at 252* where the court stated:

"However, the applicant states that while the objecting respondents would have to give up something at the present time, it would not be totally lost as they should be able to regain in the future what they are now losing."
use of the stay at a very early stage of the reorganization proceeding. By focusing on the debtor's right to posit a plan of reorganization or compromise, rather than on the protection afforded a secured creditor during the stay period, the courts place themselves in the unenviable position of having to determine the likelihood of the debtor putting forth a successful plan of reorganization at a stage of the proceedings when the parties themselves are still attempting to grapple with their respective positions. The debtor is in the panicked state of attempting to formulate a plan that will pacify all creditors, while, at the same time, attempting to determine how the business deteriorated to such an insolvent state. The secured creditors, on the other hand, are attempting to determine how the stay affects them and how best to protect their secured positions vis-a-vis the secured collateral.

The Canadian courts use various terms to describe the standard necessary for the creditor to succeed in having the stay lifted or the stay application dismissed. The courts require the opposing creditor to show that the plan is "doomed to failure"\textsuperscript{181} or that there is no reasonable "chance,"\textsuperscript{182} "prospect,"\textsuperscript{183} or "probability"\textsuperscript{184} of acceptance of a plan of arrangement or compromise. Although it has been suggested that these terms impose different standards of proof,\textsuperscript{185} it appears that the courts rely on factors such as lack of adequate protection of the creditor's interests or the conduct of the parties. Only the clearest case will allow the court to dismiss an application using one of the foregoing standards. In all other cases, the debtor should be given the benefit of the opportunity to formulate a plan \textit{provided that} it adequately protects the creditors' positions. In this manner, the courts could tailor the remedy to fit the circumstances and deal with the matter on a creditor by creditor basis. Should the debtor be unable to provide interim protection to its creditors, this may be an

\textsuperscript{181} Chef Ready, supra note 95.

\textsuperscript{182} Cango, supra note 171.

\textsuperscript{183} Bargain Harold's, supra note 81.

\textsuperscript{184} Fairview Industries Ltd. (No. 2) (1991), 109 N.S.R. (2d) 12 at 23 (N.S.S.C.).

\textsuperscript{185} H. Alec Zimmerman, "Effective Implementation" in \textit{Corporate Restructuring}, (Toronto: Canadian Institute, 1992) at 32-38.
indication that the business is not worth saving.

This approach is the one set forth in the Code, to which we will now turn our attention. We must note at the outset however, that the American system is not without its faults. The sheer volume of the cases considering this issue bears witness to this fact. However, the approach satisfies the requirement of allowing the debtor some "breathing space" while at the same time attempting to protect the interests of secured creditors. If provision is made to provide protection to creditors in Canada while the debtor is formulating a plan, the only question is how adequate the protection must be, not whether the debtor should have the opportunity to formulate a plan.

(b) Code

Subsections (d) through (g) of section 362 govern relief from the automatic stay under the Code. To obtain relief from the automatic stay, the secured creditor must take a positive step to

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186 Code ss. 362(d)-(g):

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay -

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

(2) with respect to a stay of an act against property under subsection (a) of this section, if -

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization.

(e) Thirty days after a request under subsection (d) of this section for relief from the stay of any act against property of the estate under subsection (a) of this section, such stay is terminated with respect to the party in interest making such request, unless the court, after notice and a hearing, orders such stay continued in effect pending the conclusion of, or as a result of, a final hearing and determination under subsection (d) of this section. A hearing under this subsection may be a preliminary hearing, or may be consolidated with the final hearing under subsection (d) of this section. The court shall order such stay continued in effect pending the conclusion of the final hearing under subsection (d) of this section if there is a reasonable likelihood that the party opposing relief from such stay will prevail at the
seek such relief. A court may not act *sua sponte.* Should the secured party do nothing, the stay of an act against property of estate continues until the property is no longer property of the estate and the stay of an act against the debtor continues until the case is closed or dismissed or the court grants or denies the debtor's application for a discharge, whichever is earliest.\(^{188}\)

Should the secured creditor wish to seek relief from the stay, it must request such relief by way of motion on reasonable notice to the debtor\(^ {189}\) and other interested parties,\(^ {190}\) although the court may allow the creditor to make the application on an *ex parte* basis in appropriate circumstances.\(^ {191}\) After notice and hearing,\(^ {192}\) the court shall grant relief from the stay "for cause, including lack of conclusion of such final hearing. If the hearing under this subsection is a preliminary hearing, then such final hearing shall be commenced not later than thirty days after the conclusion of such preliminary hearing.

(f) Upon request of a party in interest, the court, with or without a hearing, shall grant such relief from the stay provided under subsection (a) of this section as is necessary to prevent irreparable damage to the interest of an entity in property, if such interest will suffer such damage before there is an opportunity for notice and a hearing under subsection (d) or (e) of this section.

(g) In any hearing under subsection (d) or (e) of this section concerning relief from the stay of any act under subsection (a) of this section -

(1) the party requesting such relief has the burden of proof on the issue of the debtor's equity in property; and

(2) the party opposing such relief has the burden of proof on all other issues.


\(^{188}\) Code s. 362(c).

\(^{189}\) U.S. Bankruptcy Rules ss. 4001(a) (1), 9014.

\(^{190}\) U.S. Bankruptcy Rules ss. 1007(d), 4001(a)(1); Code s. 1102.

\(^{191}\) U.S. Bankruptcy Rules s. 4001(a)(2).

\(^{192}\) This phrase is defined in subsection 102(1) of the Code:

(1) "after notice and hearing", or a similar phrase-

(A) means after such notice as is appropriate in the particular circumstances, and
adequate protection of an interest in property of" the secured creditor. A lack of adequate protection is merely one "cause" that may result in the court granting relief from the stay and "cause" is only one alternative on which the secured creditor may rely in seeking relief from the stay. On a hearing for relief from the stay, the only issue to be considered is whether the court will grant the requested relief. Unlike the CCAA, the granting of relief from the stay may or may not dispose of the reorganization proceeding. It merely deals with the interest of the applicant party and no other interests.

The courts in the United States, like those in Canada, are reluctant to grant relief from the automatic stay in the early weeks of the proceeding. This gives all parties an opportunity to assess the situation and determine whether the creditor's security is valid, whether adequate protection is necessary and in what form and whether the possibility of formulating a successful reorganization plan is feasible.

Section 362(d) of the Code prescribes four modes of relief from the automatic stay, which are nonexclusive. The court may:

1. terminate the stay with respect to the applicant creditor or generally. Termination allows

such opportunity for a hearing as is appropriate in the particular circumstances; but

(B) authorizes an act without an actual hearing if such notice is given properly and if -

(i) such hearing is not requested timely by a party in interest; or

(ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act;

193 Code s. 362(d)(1).

194 House Report at 344.

195 Jordan and Warren, supra note 115 at 786.

the creditor to pursue its remedies to their full extent;\textsuperscript{197}

2. annul the stay which terminates it \textit{ab initio}. Annulment generally operates retroactively to
the date of the filing of the petition;\textsuperscript{198}

3. modify the stay to allow one act or one creditor to pursue a remedy, such as allowing an
action to continue to judgment but disallowing enforcement;\textsuperscript{199} or

4. place a condition on the stay that, if breached or unsatisfied, may automatically terminate
the stay.\textsuperscript{200}

Relief from the stay is mandatory, if the creditor shows cause for the granting of the relief, or, with
respect to property, the debtor does not have equity in the property and the property is not necessary
to an effective reorganization.\textsuperscript{201} Cause includes a lack of adequate protection. It also includes an
action that lacks any connection or will not interfere with the bankruptcy case, such as a personal
injury action against the debtor and its insurer\textsuperscript{202} or actions involving the debtor's postpetition

\begin{footnotes}
\item[Ibid. at 253.]
\item[198 \textit{In re Albany Partners, Ltd.}, 749 F.2d 670 (11th Cir. 1984) [hereinafter \textit{Albany Partners}]. See
also \textit{Sikes v. Global Marine, Inc.}, 881 F.2d 176 (9th Cir. 1989).
\item[199 Kennedy, supra note 196 at 254; \textit{In re Holtkamp}, 669 F.2d 505 (7th Cir. 1982).
\item[200 Blazon, supra note 44, where the court required the debtor to continue transmitting financial
information to it and to the secured creditor on a regular basis. Although the court did not order
automatic termination of the stay upon a failure of the debtor to meet the condition, it confirmed the
right of the secured creditor to apply on short notice for a revision of the order (at 865).
\item[201 One of the more important portions of the \textit{Timbers} decision is the guidance that Justice Scalia
provides concerning section 362(d)(2). In particular, His Honour set forth the burden the debtor
must meet to show that the collateral is necessary to an effective reorganization.

"What this requires is not merely a showing that if there is conceivably to be an effective
reorganization, this property will be needed for it; but that the property is essential for an
effective reorganization \textit{that is in prospect}. This means ... that there must be a reasonable
possibility of a successful reorganization within a reasonable time." [at 751, emphasis original]  

This not only provides an alternative manner for undersecured creditors to seek relief from the stay but
it also opens the door for American counsel to perhaps use some of the reasoning adopted by the
Canadian courts considering the CCAA.
\item[202 \textit{In re Holtkamp}, supra note 199.]
\end{footnotes}
activities. A stay of this type of action is unnecessary, as it is unrelated to the purpose of the stay, which is to protect the debtor from its creditors.

The debtor's *mala fides* or misconduct is another cause that may result in relief from the automatic stay. Indicia of lack of *bona fides* may be that "... there is no going concern to preserve, there are no employees to protect, and there is no hope of rehabilitation, except according to the debtor's 'terminal euphoria'."

The creditor may seek the more drastic remedies of having the case dismissed in its entirety or having the case converted to a liquidation case pursuant to section 1112. A lack of *bona fides* has been held to be grounds for dismissal of a case so that a creditor seeking relief from the stay may find the cases considering that issue useful.

An application seeking relief from the automatic stay based on "cause" invites the court to make a broad inquiry into the facts. The court will examine economic factors and may examine behavioral and equitable factors. The facts of each case will determine whether relief is appropriate in the circumstances but the courts have been responsive to many types of requests. Although the facts may not warrant a complete dismissal or conversion of the case, facts evidencing the "causes"

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207 *Albany Partners, supra* note 198.

208 Nimmer, *supra* note 165 at 284. A recent example of a court considering behavioral factors in reaching its decision was in *In re Kleinman*, 156 B.R. 131 (Bankr. S.D.N.Y.), where the court granted the secured creditor relief from the automatic stay and, in so doing, noted the financial irresponsibility of the debtors and the fact that one of the debtors "has undertaken a scorched earth campaign of litigation, including making numerous attacks on the court's integrity." [at 132].

209 House Report at 344.
listed in section 1112(b) of the Code may be sufficient to obtain relief from the stay.\textsuperscript{210}

Under paragraph 362(d)(2), which is the second ground for seeking relief from the automatic stay, the secured creditor has the burden of proof on the issue of the debtor's equity in the property and the debtor has the burden of proof on all other issues.\textsuperscript{211} The two elements comprising paragraph 362(d)(2) are that the "debtor does not have an equity in such property" and "such property is not necessary to an effective reorganization." The paragraph requires both elements to be present for the relief to be granted. If both elements are not present, the court will dismiss the application but the secured creditor may attempt to show a lack of adequate protection at that hearing, or subsequently, or

\textsuperscript{210} Code, s. 1112(b):

(b) Except as provided in subsection (c) of this section, on request of a party in interest or the United States trustee, and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 7 of this title or may dismiss a case under this chapter, whichever is in the best interest of creditors and the estate, for cause, including -

(1) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation;

(2) inability to effectuate a plan;

(3) unreasonable delay by the debtor that is prejudicial to creditors;

(4) failure to propose a plan under section 1121 of this title within any time fixed by the court;

(5) denial of confirmation of every proposed plan and denial of a request made for additional time for filing another plan or a modification of a plan;

(6) revocation of an order of confirmation under section 1144 of this title, and denial of confirmation of another plan or a modified plan under section 1129 of this title;

(7) inability to effectuate substantial consummation of a confirmed plan;

(8) material default by the debtor with respect to a confirmed plan;

(9) termination of a plan by reason of the occurrence of a condition specified in the plan; or

(10) nonpayment of any fees or charges required under chapter 123 of title 28.

\textsuperscript{211} Code s. 362(g).
some other "cause" entitling it to relief from the stay.

In determining whether the debtor has equity in the property, the court looks at the difference between the property value and the total value of the liens against the property and not just the value of the lien of the creditor seeking relief from the stay plus all senior liens.\textsuperscript{212} With respect to the second element, the courts have embraced the requirement established by \textit{Timbers} that the debtor must show a reasonable prospect for a successful reorganization within a reasonable time.\textsuperscript{213} It is insufficient for a single-asset debtor to argue that it requires the sole asset for an effective reorganization\textsuperscript{214} or that the property is indispensable to the debtor's survival and ultimate rehabilitation.\textsuperscript{215}

(c) BIA

Section 69.4 governs the lifting of the automatic stay. It provides:

69.4 A creditor who is affected by the operation of sections 69 to 69.3 may apply to the court for a declaration that those sections no longer operate in respect of that creditor, and the court may make such declaration, subject to any qualification that the court considers proper, if it is satisfied

(a) that the creditor is likely to be materially prejudiced by the continued operation of those sections; or

(b) that it is equitable on other grounds to make such a declaration.

In addition, however, the secured creditor may effectively terminate the stay by successfully challenging an extension of the period within which the insolvent person may file a proposal pursuant to section 50.4(9), or by having the period within which the insolvent person may file a proposal terminated pursuant 50.4(11).

\begin{footnotes}
\item[212] \textit{Stewart v. Gurley}, 745 F.2d 1194 (9th Cir. 1984).


\item[214] Bienenstock, \textit{supra} note 164 at 135-136.

\item[215] Norton Bankr Law & Practice s. 20.27.
\end{footnotes}
Section 69.4 gives the court some discretion in the remedy it may grant, although the forms of relief are not as extensive as those under the Code. For example, whether the court has the jurisdiction to retain the stay, on the insolvent person providing the secured creditor with adequate protection, is questionable. Although courts have equitable jurisdiction, the wording of section 69.4 does not appear to support the argument that the court may exercise that jurisdiction in these circumstances. On a strict reading of the section, the court may "make such a declaration," being a "declaration that [the stay provisions] no longer operate in respect of that creditor." That is, the court may either lift the stay or retain the stay.

However, the court may make the declaration "subject to any qualification that the court considers proper." Should the court deny the application, it cannot impose a condition on that order. The stay would continue to unconditionally bind the secured creditor. The court could, however, grant leave to reapply under section 69.4, on short notice, should circumstances change. Should the court grant the application and make the declaration that the stay provisions no longer operate in respect of that creditor, the court could stay the operation of the order so long as the insolvent person makes periodic payments, provides a replacement or additional lien, or provides some other type of adequate protection. This would meet the objective of the proposal provisions and the stay period would not prejudice secured creditors. If the courts take an absolute approach by lifting or retaining the stay, without qualifications, either the business reorganization objective will be completely frustrated, by leaving the insolvent person without cash flow, key assets or any assets with which to reorganize, or secured creditors will be materially prejudiced by allowing the insolvent person to continue to use or expend the collateral, without compensation. The courts must devise some compromise position. Although the wording of section 69.4 is not as clear in that respect as section 362 of the Code, an opening exists within which to accommodate such a position.

Subsection 69.4(a) provides that the court may lift the stay in respect of the applicant creditor.

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216 BIA s. 187(11).
if that creditor is likely to be "materially prejudiced" by the continued operation of the stay. Denying the secured creditor its right to realize on its collateral immediately is prejudicial, to a certain extent. However, it is difficult to conceive of when the prejudice becomes "material" and when, even if the prejudice is material, the secured creditor's interests outweigh the public policy interests of encouraging business reorganizations. "Material prejudice" is beneficial as it attempts to focus on protecting the secured creditor rather than on the insolvent person's right to effect a reorganization. The term also provides the court with some flexibility, which is also beneficial, as the decisions will hopefully ebb and flow with the tides of business. However, the BIA does not give the courts any guidance concerning this matter and it is possible that a stay of whatever magnitude and for whatever period may be considered materially prejudicial. Should the concept evolve in such a manner, the amendments will have accomplished nothing. On the other hand, if the courts interpret the standard of proof of material prejudice narrowly, they will deny secured creditors of the benefit of their respective bargains, which will have dire effects on the credit market generally.\(^{217}\) The material prejudice standard will likely fall between the two extremes. However, the concept is so amorphous that each interpretation will be fact specific. This will undoubtedly result in much litigation and very few answers.\(^{218}\)

There have been no reported cases to date that confront this issue directly, although the few cases dealing with lifting the stay or other remedies sought by creditors may provide us with a preview of how the courts will approach these matters and the scope of the automatic stay. The courts may

\(^{217}\) Whether secured creditors should bear any cost in a business reorganization at all will be discussed, chapter V(5), below.

\(^{218}\) Not unlike the litigation attempting to define the doctrine of "reasonable notice" which started in earnest with *Ronald Elwin Lister Ltd. v. Dunlop Canada Ltd.*, [1982] 1 S.C.R. 726 and which continues today. Although there have been many cases considering this issue, the doctrine is so fact specific that few lawyers, with certainty, will opine on an absolute minimum amount of notice.
place considerable emphasis on the conduct of the parties.\textsuperscript{219} For example, the cooperation of the
debtor and its principals may tip the balance in favour of requiring the stay to remain in place.\textsuperscript{220}

However, if the debtor commences a proposal proceeding in bad faith as a sham or delaying tactic, the
court may be inclined to censure the insolvent person by lifting the stay.\textsuperscript{221} One court stated, as \textit{obiter
dictum}, that it would be materially prejudicial to a secured creditor if the debtor sold the collateral at
"fire sale" prices to allow the debtor to attempt to stay in business by generating cash flow from the
collateral.\textsuperscript{222}

One of the grounds justifying termination of the period within which the insolvent person may
file a proposal is if "the creditors as a whole would be materially prejudiced were the application
under this subsection rejected."\textsuperscript{223} The court, in \textit{N.T.W.},\textsuperscript{224} interpreted that section to mean that all of
the creditors must be materially prejudiced for the applicant to succeed on this ground. It held that,
although the delay caused the secured creditor prejudice, the insolvent person was permitted to
continue to use secured funds to operate the companies, while making no payments to the secured
creditor. This decision makes that ground very difficult or impossible for a secured creditor to rely
on, as any action taken by the court for its benefit would likely have a detrimental effect on the

\textsuperscript{219} See \textit{e.g.}, \textit{156190 Canada Ltd. v. Boursoum Drugs Ltd.} (1993), 19 C.B.R. (3d) 129 (N.W.T.S.C.)
Construction Ltd} (1993), 19 C.B.R. (3d) 94 at 100 (N.S.S.C.). See also Nimmer, \textit{supra} note 165 at
298-300.

\textit{N.T.W.}], which was not an application for relief from the stay but was an application pursuant to
section 50.4(11) of the BIA for an order terminating the notice of intention; \textit{Re High Street
was dealing with an extension of time to file a proposal under section 50.4(9) of the BIA. See also
Nimmer, \textit{supra} note 172 at 301-303.

\textsuperscript{221} See \textit{e.g.}, \textit{Re Malenfant} (1993), 19 C.B.R. (3d) 295 (Que. S.C.).

\textsuperscript{222} \textit{156190 Canada Ltd.}, \textit{supra} note 219.

\textsuperscript{223} BIA s. 50.4(11)(d).

\textsuperscript{224} \textit{N.T.W.}, \textit{supra} note 220.
unsecured or junior secured creditors. The decision in this case, may have been based on the protection accorded to the secured creditor during the stay. The court provided directions to the interim receiver "to protect the interest" of the creditor. The secured creditor may have felt that this protection was adequate as it adjourned its application under subsection 50.4(11) *sine die*.

One of the requirements that an insolvent person must show to obtain an extension of the time within which to file a proposal is that "no creditor would be materially prejudiced if the extension being applied for were granted." In *High Street*, the court held that the applicant was not materially prejudiced by the failure of the debtor to pay the arrears of interest on the outstanding indebtedness to the applicant and accruing realty taxes. This case is noteworthy, as the court suggested that the secured creditor was adequately protected because the secured assets "are non-depreciating and cannot be dissipated" and the stay did not prevent the secured creditor from "issuing its notice of sale with respect to its mortgages."

Although the courts attempt to avoid using the CCAA cases to arrive at their decisions, the same thought processes are operating. In *High Street*, the court cited *Elan* and *Ultracare Management Inc. v. Zevenberger (Trustee of)* and held that the secured creditor could not say that it would not accept the insolvent person's proposal under any circumstances. The court in *N.T.W.* also

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225 Ibid. at 164.

226 BIA s. 50.4(9)(c).

227 *High Street*, supra note 220.

228 Ibid. at 215.

229 Ibid.

230 In fact, the *N.T.W.* case, supra note 220, explained some of the features which distinguish the two acts.

231 *Elan*, supra note 97.

made the following comment that is reminiscent of the CCAA cases:

The question is whether they "will not be likely able to make a viable proposal." It is difficult to make this determination so early in the proceedings. It is clear that for any proposal to be viable it will have to contain provisions for a complete discharge of the C.I.B.C. obligation. The evidence indicates the principals are negotiating with other banks to arrange new take-out financing. The onus is on the applicant to prove on a balance of probabilities that the insolvent companies will likely not be able to make a viable proposal before the expiration period. The applicant has not met this onus.\textsuperscript{233}

The second ground for declaring that the stay is no longer applicable to the applicant gives the court considerable discretion in balancing the equities of the case. That ground is "that it is equitable on other grounds to make such a declaration.\textsuperscript{234} N.T.W. considered this ground and retained the stay on the basis that to grant the application would effectively defeat the proposal and accordingly, it was inequitable, as it, would prejudice all other creditors.\textsuperscript{235}

These sections have received only limited consideration to date. Accordingly, it is difficult to draw any convincing conclusions. However, the cases serve to illustrate the difficulties the courts must face, without legislation providing clear guidance. A further concern is that the nature of the legislation may not lend itself to the development of general principles to guide business people and their advisors. It is hoped that the closing paragraph of \textit{High Street} does not foreshadow this concern:

At the conclusion of this application counsel for T.D. noted that I must be cautious in granting this extension. I have made my decision based on the particular facts of this application and my findings that High Street has satisfied the three prerequisites for an extension under s. 50.4(9) of the Act.\textsuperscript{236} [Emphasis added]

5. \textbf{Analysis of the BIA and Proposals for Reform}

The Tassé Report recommended that, on the filing of a notice of intention to present a proposal, the debtor would receive "... a short stay of proceedings during which the debtor could

\textsuperscript{233} \textit{N.T.W.}, supra note 220 at 167-168.

\textsuperscript{234} BIA s. 69.4(6).

\textsuperscript{235} \textit{Ibid}.

\textsuperscript{236} \textit{High Street}, supra note 220 at 266.
formulate his proposal and arrange the necessary financing, guaranties and other details.\textsuperscript{237} The Colter Committee Report adopted this notion and recommended a 21-day period.\textsuperscript{238} The BIA actually adopted a 30-day period during which time, the insolvent person must to file a cash-flow statement and apply for any extension of the 30-day period. The question is whether these periods realistically allow the debtor time to formulate its proposal and arrange the necessary financing. We must also remember that an entity intending to file a proposal is insolvent, by definition. Is it reasonable to require such a person to retain a trustee to certify the cash-flow statement and a lawyer to apply for an extension of the 30-day period? As it was the intent of the policymakers that the BIA deal with a broad range of fact patterns, it might have been more prudent to avoid strict periods of time and allow the courts to deal with the time periods on a case by case basis, as is presently done under section 11 of the CCAA and under section 362 of the Code. This would allow the court (or the parties) to determine, for example, the time required by the debtor to secure financing for the proposal or whether financing is indeed available. The time periods will vary depending on the nature and size of the business to be reorganized. The foregoing illustrates that perhaps the policymakers failed to consider practical realities and the difficulties of attempting to balance the conflicting interests of the parties.

This brings us back to the original purpose of this chapter which is, to attempt to determine the objectives of a business reorganization proceeding. If an objective is to balance the respective interests of creditors and debtors with a view to having the debtor emerge as a healthy, viable business, the BIA has failed. The system, as presently structured, gives the debtor a limited environment within which to reorganize in terms of time and substantive rights. While a demand for repayment of a loan or a notice of intention to realize on security usually comes as no surprise to the debtor, it usually results in a flurry of activity by the debtor, attempting to stave off the secured creditor, seeking alternate debt or equity financing and keeping the business operating. The debtor

\textsuperscript{237} Tassé Report at 175.

\textsuperscript{238} Colter Committee Report at 56.
spends little time on formulating a workable plan which requires not only analyzing external matters such as alternate financing and market conditions, but also internal factors such as the history of the business that resulted in the financial difficulties and how to solve the problems. While one might argue that the debtor had ample opportunity to consider these matters before the creditor served the demand or notice, few debtors actually face the reality of the financial difficulties. Instead they choose to immerse themselves in their work in the hopes that the problem will disappear with increased productivity.

The debtor also faces substantive problems created by the BIA that, combined with the time limitations, make formulation of a viable proposal very difficult. A secured creditor that has taken possession of the collateral prior to the notice of intention to make a proposal being filed or has given the debtor a notice of intention to enforce security more than 10 days before the notice of intention to make a proposal is filed, is free to continue its realization proceedings.\textsuperscript{239} A significant secured creditor, in the former case, may completely frustrate any possibility of the debtor making a proposal. Should Parliament repeal the CCAA, this would leave the debtor no alternative but to liquidate or attempt to redeem or purchase the collateral at the foreclosure, judicial or private sale. To avert the running of the 10-day period in the latter case, the debtor may be forced to file a notice of intention to make a proposal, simply to invoke the stay and obtain some "breathing space." If no reorganization is possible, this delays the secured creditor in its realization proceedings, for no useful purpose.

The structure of the BIA is also unsatisfactory to secured creditors. Given the stated objectives of the legislation and the inclination of courts in the early stages of the reorganization proceeding to give the debtor an opportunity to put forth a plan of reorganization, it is highly unlikely that the court will grant the secured creditor a declaration that the stay no longer operates with respect to that creditor. Therefore, the creditor loses its bargained-for rights, usually without compensation.

\textsuperscript{239} BIA ss. 69(2), 69.1(2); See Metropolitan Trust Co. of Canada v. Novastar Development Corp. (1993), 19 C.B.R. (3d) 140 (B.C.S.C.).
Prior to suggesting an alternate manner of proceeding, it is necessary to set forth the normative basis of the model.

Bankruptcy law does not exist in a vacuum, yet one cannot spend much time reading in the field without noting that few judges or scholars have taken this observation to heart. Too many seem to think that a bankruptcy proceeding provides, in the main, an essentially unlimited opportunity to do what appears at the moment to be good, just or fair without regard to the reasons for having a system of bankruptcy laws in the first place.\textsuperscript{240}

The primary objective of a business reorganization system should be to aid businesses that have the capacity and capability of surviving in the current marketplace. Conversely, not all businesses in all circumstances should have a right to attempt a reorganization. Although one writer described the American business reorganization system as "a rejection of economic Darwinism,"\textsuperscript{241} it is suggested that the system is or should be Darwinism in its most pure form. The fittest should survive and the unfit should perish, unless they reorganize in a way that will allow them to survive in the changing environment.

To accomplish the primary objective, it is necessary to determine whether the debtor is fit or unfit. The automatic stay of proceedings allows the parties the time to make that determination. During the stay, the legislation or the courts must protect the rights of secured creditors. This does not derogate from the debtor's rights, as the stay provides the debtor its most valuable resource, time. If the secured creditor is provided adequate protection, it should have no difficulty in even a protracted stay period as its "bargain"\textsuperscript{242} is preserved.\textsuperscript{243} In this manner, the reorganization scheme balances the


\textsuperscript{242} The term "bargain" is used not to indicate the bargain which was negotiated by the parties at the commencement of their relationship. Rather, it is the bargain which is in effect immediately following the debtor seeking the protection of the BIA. It is at this moment in time, that for example, valuation of the property is made, quantification of the debts is made and it is the reference point for determining pre-filing and post-filing conduct.
interests of the debtor and secured creditor.

The model also accounts for interests of the subordinate secured creditors and unsecured creditors in that they gain the same benefit as the debtor. In the event of a liquidation, at best, those creditors would receive a portion of their secured debts, in the case of subordinate secured creditors, or their pro rata share of the residual amount after payment of all secured and preferred claims, in the case of unsecured creditors. Should the reorganization be successful, they would receive those amounts plus their respective share of the enhanced value of the going-concern enterprise. Subordinate secured creditors whose security has some value would receive adequate protection based on that value.

As reorganization is a collective proceeding, a secured creditor must not expect to receive the full value of its bargain. Therefore, adequate protection must be based on the value of its interest in the property as at the date of the stay, not the value of its debt. Usually, the value would be the lesser of the amount of the debt and the liquidation or net realizable value of the collateral. Liquidation or net realizable value is a concept distinct from a going-concern value. The secured creditor would be entitled to only the reduced value, as that is all it would realize in a liquidation or bankruptcy scenario, on the date the proposal proceeding is commenced. However, the legislation should give the courts considerable flexibility with respect to valuation issues to apply properly the valuation concept in light of the facts of the case, the conduct of the parties and other general equitable principles.\textsuperscript{244}

Any reforms should also give the courts flexibility in establishing methods of adequate protection. Periodic payments should be the most common method of adequate protection. While, in many instances, the debtor's problems are the result of a lack of cash flow,\textsuperscript{245} we must remember that

\begin{footnotesize}

\textsuperscript{244} House Report at 339.

\end{footnotesize}
the secured creditor is entitled to only reduced payments (based on valuations using the foregoing model) and the stay operates to prevent secured creditors from further collection efforts during that period. Should cash still be a problem, the debtor must look to third party investors, subordinate creditors or additional financing. This is where "economic Darwinism" is most evident as, "[a]n inability to persuade anyone . . . that the firm should stay alive seems good evidence that it should not."\(^{246}\)

Similarly, debtors may not have any unencumbered assets or assets that possess a significant "collateral cushion" in which to grant the secured creditor an additional or replacement lien.\(^{247}\) However, this should not derogate from the utility of an additional or replacement lien in appropriate circumstances.

Periodic cash payments and additional or replacement liens are merely two examples of methods of adequate protection. Should the policymakers accept the concept of adequate protection, then giving courts the necessary flexibility to develop and adapt the concept to changing circumstances should pose little difficulty. If the policymakers give the courts jurisdiction to provide adequate protection they consider necessary or appropriate in the circumstances, this will allow the required flexibility, without having to address the issue of whether and to what extent adequate protection should be "completely compensatory"\(^{248}\) and whether the secured creditor should receive the "mere indubitable equivalent" or the "most indubitable equivalent."\(^{249}\) We may learn from the American experience by avoiding the term "indubitable equivalent" and providing the court a general discretion.

\(^{246}\) Jackson and Baird, supra note 240 at 128.

\(^{247}\) Karlen, supra note 33 at 32; D. Price "Adequate Protection Under the Bankruptcy Act of 1978" (1982-83) 71 Ky. L.J. 727 at 739.

\(^{248}\) Murel, supra note 38.

\(^{249}\) W.J. Wahoff, "The Adequate Protection of Secured Creditors in Termination of Stay Litigation Under the Bankruptcy Code" (1982) 43 Ohio St. L.J. 715 at 730. Baird and Jackson, supra note 240 have described this debate as one that is conducted in a "vacuum" and ignores the purposes of business reorganization legislation.
An "equity cushion" should not be adequate protection in and of itself as it fails to recognize the commercial reality of secured creditors generally requiring a "collateral cushion" to cover accrued interest, expenses and other costs incurred in realizing on collateral. Of course, a significant equity cushion could suffice in appropriate circumstances.\textsuperscript{250} However, the courts must rely on the commercial lending community to advise on the appropriate collateral cushion required in any given circumstance. The underlying policy, in this situation, should be commercial reasonableness as that term is used in the Uniform Commercial Code and various personal property regimes used in Canada.\textsuperscript{251}

The reforms should require the debtor to propose a method of adequate protection, once the secured creditor requests it. This is appropriate, as the debtor is best able to determine the capacity of the business and the opportunities for third party financing. It also gives the debtor an opportunity to explore novel methods of adequate protection, without being constrained by precedent.

The policymakers should retain the concepts incorporated in section 69.4 of the BIA, as those concepts provide the court with flexibility concerning the conduct of the parties, determining whether a successful reorganization is likely, whether the property is necessary for a successful reorganization, whether the debtor is making progress toward a successful reorganization and generally, other equitable factors that may govern in the circumstances.\textsuperscript{252} The case law under the CCAA concerning

\textsuperscript{250} Such as in \textit{Blazon}, supra note 44.

\textsuperscript{251} \textit{E.g.}, Section 66(1) of the Alberta \textit{Personal Property Security Act}, S.A. 1988, c. P-4.05 and section 68(2) of the British Columbia \textit{Personal Property Security Act}, S.B.C. 1989, c. 36 read, respectively, as follows:

\begin{quote}
66(1) All rights, duties or obligations arising under a security agreement under this Act or under any applicable law shall be exercised or discharged in good faith and in a commercially reasonable manner.

68(2) All rights, duties or obligations arising under a security agreement, this Act or any other law applicable to security agreements or security interests shall be exercised or discharged in good faith and in a commercially reasonable manner.
\end{quote}

\textsuperscript{252} Kennedy, \textit{supra} note 196 at 238-253.
the likelihood of a successful reorganization will be useful in developing common law guidelines in this regard. However, the relief that the courts may grant should include the right to modify or condition the stay. Termination of the stay is already included in the present wording and the courts, in appropriate circumstances, grant leave to proceed *nunc pro tunc* under related provisions.\textsuperscript{253} Although, as suggested earlier, the courts have the capacity to make more flexible orders under section 69.4 and then qualify the declaration, a specific mandate to modify or condition the stay is a more appropriate manner of dealing with this concern.

If adequate protection is provided to secured creditors, the legislation could extend the periods set forth in the BIA. The current time periods are simply not commercially reasonable.\textsuperscript{254} In addition, the legislation should give the courts sufficient flexibility to determine appropriate time periods, although it should prescribe some guidelines as to the *longest period* within which the debtor must complete the proceeding. The CCAA cases suggest that the courts do not want to see the reorganization process go on *ad infinitum*. The period of 6 months in the case involving Quintette Coal Limited seemed to most practitioners to be an extraordinarily long period, although it has been suggested that this is the minimal period in complex cases.\textsuperscript{255} To be granted an extension beyond that period or the initial period granted by the court, the courts should require the debtor to show extraordinary circumstances.

The foregoing model better addresses the objectives of a business reorganization statute. Although it adopts many concepts developed under the Code, it seeks to avoid some of its pitfalls and inequities.

\textsuperscript{253} See BIA s. 215; *see e.g.* *Re New Alger Mines Ltd.* (1986), 59 C.B.R. (N.S.) 113 (Ont. C.A.).

\textsuperscript{254} See discussion, *supra* note 238 and accompanying text.

\textsuperscript{255} Fitch, *supra* note 103 at 107.
B. REPUDIATION OR REJECTION OF REAL PROPERTY LEASES

This section will examine the issue of whether the provisions of the BIA allowing an insolvent commercial tenant to repudiate a lease of real property256 fosters the rehabilitation goals of the debtor,257 given their onerous financial burdens. Few tenants will choose to reorganize under the BIA. Instead, they will resort to the CCAA which presents a more flexible regime within which to reorganize.

This section will examine the right of a tenant to repudiate or reject its leases as part of a reorganization proceeding under the BIA or the CCAA and undertake a functional comparison between the Canadian provisions and approaches and those taken in the United States pursuant to the Code. The purpose of this section is to determine whether Canadian policymakers should reexamine the policy underlying the BIA and, in particular, whether an effective reorganization and rehabilitation system for insolvent debtors should form a part of bankruptcy and insolvency system. Should the policymakers conclude that reorganization and rehabilitation of insolvent debtors is a laudable objective, they must effect certain reforms to make the BIA more accessible.

1. Legislative History

The 1919 version of The Bankruptcy Act258 contained provisions that attempted to deal with the interests of the landlord in having the provisions of its lease enforced and those of the trustee who required the demised premises to conduct an orderly disposition of the bankrupt's estate and to dispose of the lease as an asset of the bankrupt. Subsection 52(S) of the 1919 Act provided that, on the

256 This section will deal only with the repudiation or rejection of real property leases by insolvent commercial tenants. Accordingly, when reference is made to a "tenant" or "debtor", such reference is to an insolvent commercial tenant or a tenant carrying on business in the demised premises. Similarly, when reference is made to a "lease", such reference shall be to a lease of real property in which the tenant is carrying on business.

257 BIA division I of part III.

258 S.C. 1919, c. 36 [hereinafter the 1919 Act].
bankruptcy of the tenant, the trustee could elect to disclaim the lease or retain the premises for the unexpired term of the lease or such period as the trustee considered appropriate. If the trustee elected to retain the demised premises, that provision required the trustee to abide by the terms of the lease. Subsection 52(6) of the 1919 Act allowed the trustee to assign or sublet the demised premises, provided there was no provision in the lease prohibiting assignment or subletting. These rights did not arise on an insolvent tenant taking advantage of the proposal provisions of the 1919 Act. In that situation, the insolvent tenant could disclaim the lease as part of the proposal and the creditors, including the landlord, would determine whether to accept the proposal. The legislation gave the landlord additional protection, however, as the court could not approve a proposal that did not provide for full payment of priority debts. Subsection 52(1) gave the landlord a priority claim for the lesser of the value of the distrainable assets on the demised premises and three months accrued rent.

The Bankruptcy Act Amendment Act, 1921 repealed subsection 52(6) and replaced it with a provision that expanded the right of the trustee to disclaim a lease. Following the disclaimer, there was no obligation to make any payment to the landlord, other than the priority payment referred to earlier.

In 1923, Parliament repealed section 52 of the 1919 Act and replaced it with a provision that, upon the bankruptcy of the insolvent tenant, the laws of the province in which the demised premises are located shall determine the rights and priorities of the landlord. Provincial law

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259 1919 Act s. 13.

260 1919 Act s. 13(16).

261 S.C. 1921, c. 17, s. 42.

262 Supra note 260 and accompanying text.


264 The Bankruptcy Amendment Act, 1923, S.C. 1923, c. 31, s. 31 [emphasis added]. The constitutionality of the right to repudiate or reject real property leases in a reorganization proceeding has been upheld in the United States and Canada.
continues to determine the rights of landlords under the BIA.265

The Bankruptcy Act, 1949266 maintained provisions concerning landlords similar to the 1919 Act, as amended. That is, provincial legislation would govern the rights of landlords267 in the case of a tenant's bankruptcy and, to obtain court approval of a proposal, the proposal had to provide for payment in full of preferred claims.268 The 1949 Act contained no specific provision for the disclaimer of leases in the formulation of proposals.

The Tassé Report recommended that any reform, should allow the debtor, "with suitable

In the United States, it has been held that the rights of a landlord under a lease "may be constitutionally altered by Congress in the exercise of its bankruptcy powers." [In re Sweetwater, 40 B.R. 733 at 741 (Bankr. D. Utah 1984) [citations omitted]].

Although the constitutionality of section 365 of the Code has been challenged on the basis that it violates the due process requirements of Fifth Amendment, a similar provision in the 1898 U.S. Act was upheld by the United States Supreme Court in Kuehner v. Irving Trust Co., 299 U.S. 445 (1937). The court stated:

"While, therefore, the Fifth Amendment forbids the destruction of a contract it does not prohibit bankruptcy legislation affecting the creditor's remedy for its enforcement against the debtor's assets, or the measure of the creditor's participation therein, if the statutory provisions are consonant with a fair, reasonable, and equitable distribution of those assets. The law under consideration recognizes the [landlord's] claim and permits it to share in the consideration to be distributed in reorganization." [at 452].

Recently, the Cour Supérieure du Québec upheld the constitutionality of section 65.2 of the BIA on the basis that it is legislation promulgated pursuant to Parliament's authority to enact legislation in matters of bankruptcy and insolvency [Re Janpar Produits de Bureau Inc. (1993), 20 C.B.R. (3d) 8 (C.S. Qué.) [hereinafter Janpar; headnote reference only]].

265 BIA s. 146:

146. Subject to priority of ranking as provided by section 136, and subject to subsection 73(4), the rights of landlords shall be determined according to the laws of the province in which the leased premises are situated.

266 S.C. 1949, c. 7 [hereinafter, in this section, the 1949 Act]. The 1949 Act, although amended from time to time, formed the foundation for the legislation which was in effect immediately preceding the passage of the amendments which resulted in the BIA. The provisions discussed in this section were not substantially affected by any of the pre-1992 amendments.

267 former Canadian Act s. 105.

268 1949 Act s. 34(4).
safeguards," to disclaim contracts or leases.\textsuperscript{269} The Tassé Report also recommended that, if the landlord minimized its losses, it could make a claim for damages in the arrangement. It recognized that without this right, the debtor might have problems in coming to an arrangement with its creditors.\textsuperscript{270}

The Colter Committee Report went further by recommending that any reforms should allow a debtor who intends to or has filed a proposal to apply to the court for an order allowing the repudiation or variation of an executory contract.\textsuperscript{271} To secure such an order, the report recommended that the debtor must show, \textit{inter alia}, that the lease was onerous and that it rendered the reorganization "impractical."\textsuperscript{272} In dealing with the existing preferred claim of landlords, the Colter Committee Report recommended:

\ldots in 1985, such additional protection is unwarranted, although provincial law does give such a priority. A landlord's claim should be treated equally with the claims of other unsecured creditors and the landlord's privilege should be abolished.\textsuperscript{273}

These recommendations removed any incentive for a landlord to reject a proposal simply on the basis that, on a liquidation, it would receive its priority payment.\textsuperscript{274} By retaining the priority payment in the BIA, Parliament had to make some provision for landlords to make the proposal

\begin{itemize}
\item[\textsuperscript{269}] Tassé Report at 96.
\item[\textsuperscript{270}] Ibid.
\item[\textsuperscript{271}] Colter Committee Report at 58. The Colter Committee Report did not make specific provision for leases, which for the purposes of this portion of the discussion, will be treated as executory contracts.
\item[\textsuperscript{272}] Colter Committee Report at 59.
\item[\textsuperscript{273}] Colter Committee Report at 80.
\item[\textsuperscript{274}] BIA s. 136(1)(f) gives the landlord a preferred claim for:
\end{itemize}

\"... arrears of rent for a period of three months immediately preceding the bankruptcy and accelerated rent for a period not exceeding three months following the bankruptcy if entitled thereto under the lease, but the total amount so payable shall not exceed the realization from the property on the premises under the lease, and any payment made on account of accelerated rent shall be credited against the amount payable by the trustee for occupation rent;\"
attractive.

The CCAA contains no express provision allowing for the repudiation, disclaimer or rejection of executory contracts or unexpired leases. However, courts allow the debtor to disclaim leases pursuant to the general provisions of the CCAA.275

The 1898 U.S. Act did not contain any provisions allowing the debtor to reject unexpired leases. Section 77B provided, *inter alia*, "[a] plan of reorganization within the meaning of this section . . . may reject contracts of the debtor which are executory in whole or in part, including unexpired leases . . .". It goes on to (a) provide that any person injured by the rejection of an executory contract or unexpired lease shall be considered a creditor, (b) limit the amount of the landlord's claim and (c) provide the priority of that claim.276 The Chandler Act added a provision that the rejection of an unexpired lease "shall constitute a breach of such . . . lease as of the date of the filing . . . of the original petition [for reorganization]"277 and provisions:

(a) limiting the time within which a trustee may reject or assume the unexpired lease;

(b) allowing the court, for cause, to extend or abridge such time;

(c) providing that should the trustee not assume or reject the unexpired lease within such time, the lease shall be deemed to be rejected;

(d) prohibiting a general covenant against assignment but allowing an express covenant that an assignment by operation of law or the bankruptcy of either party shall terminate or give the other party the option to terminate the lease; and

(e) protecting the trustee from liability for breaches of the lease following an assignment of the lease to a third party.278

These provisions, as amended from time to time,279 remained in force until the enactment of

275 CCAA ss. 4 and 5.

276 77B(b)(6).

277 Chandler Act s. 63c.

278 Chandler Act s. 70b.

279 See generally, V. Countryman, "Executory Contracts in Bankruptcy: Part I" (1972/73) 57 Minn. L. Rev. 439 at 448.
section 365 of the Code. The provisions of the Code remained in effect for approximately 6 years until, in 1984, a strong lobby by shopping centre organizations resulted in the 1984 Amendments that effected significant amendments to section 365.280

2. Repudiation / Rejection

The Code allows the trustee281 to reject an unexpired lease of the debtor.282 The BIA, on the other hand, allows an insolvent person to repudiate a lease.283 Is there a functional difference between repudiation and rejection? Furthermore, would an alternate description of the effective concept be preferable?

Repudiation284 of a lease of real property by the debtor does not ipso facto terminate the lease. To accomplish that object, the landlord must accept the repudiation.285 This excuses the landlord from further performance of its obligations under the lease and entitles the landlord to commence an action for damages that have accrued because of the breach, including damages resulting from prrepudiation

280 Rather than discussing the Congressional hearings at this juncture, reference will be made in succeeding pages to germane portions of the hearings.

281 Reference to the term "trustee" in the context of the Code refers also to a debtor in possession. See discussion chapter IV, above.

282 Code s. 365(a) provides:

"Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."

283 BIA s. 65.2(1) provides:

"At any time between the filing of a notice of intention and the filing of a proposal, or on the filing of a proposal, in respect of an insolvent person who is a commercial tenant under a lease of real property, the insolvent person may repudiate the lease on giving thirty days notice to the landlord in the prescribed manner, subject to subsection (2)."

284 The concept of repudiation has been held to apply to leases of real property. See Highway Properties Ltd. v. Kelly, Douglas & Co. (1971), 17 D.L.R. (3d) 710 at 717 (S.C.C.) [hereinafter Highway Properties].

breaches. In other words, acceptance of the repudiation does not destroy the lease. It merely terminates future performance of the lease obligations by the landlord and the debtor, but the liabilities flowing from the repudiation subsist.

Alternatively, the landlord may disregard the repudiation, which maintains the lease in full force for the benefit of both parties. In that case, the landlord may insist on performance of the lease obligations by the debtor and "sue for rent and damages on the footing that the lease remains in full force." Although the landlord need not mitigate its damages in this type of case, reletting the premises would be considered de facto mitigation. Should the landlord not accept the repudiation, it would also have the option of seeking to enforce the lease through specific performance.

In *Highway Properties*, Laskin J. (as he then was) summarized the concept of repudiation as follows:

> Although it is correct to say that repudiation by the tenant gives the landlord at that time a choice between holding the tenant to the lease or terminating it, yet at the same time a right of action for damages arises; and the election to insist on the lease or to refuse further performance (and thus bring it to an end) goes simply to the measure and range of damages.

Practically, absent a bankruptcy proceeding, the measure of damages and the prospects of collecting them determines, at least in part, the issue of whether the landlord will accept the

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289 Harbutt's "Plasticine" Ltd. v. *Wayne Tank and Pump Co. Ltd.*, [1970] 1 Q.B. 447 at 464-465. (C.A.); *Cromwell v. Morris*, [1917] 2 W.W.R. 374 at 377 (Alta. C.A.). See also *Highway Properties*, supra note 284, where the court proposed a further alternative. The landlord could exercise its option to terminate the lease and advise the tenant that it would be seeking damages based on the present value of the lease payments for the unexpired portion of the term [at 570].

290 *Highway Properties*, supra note 284 at 570.

291 *Highway Properties*, supra note 284 at 572.

292 Ibid. at 576.
repudiation. In a proposal proceeding, the BIA fixes the quantum of damages. Subsection 65.2(3) provides:

Where a lease is repudiated pursuant to subsection (1), a proposal filed by the insolvent person must provide for payment to the landlord, immediately after court approval of the proposal, of compensation equal to the lesser of

(a) an amount equal to six months rent under the lease, and
(b) the rent for the remainder of the lease, from the date on which the repudiation takes effect.

There is no question of mitigation by the landlord or economic circumstances that may entitle the landlord to damages exceeding those set forth in the BIA. Therefore, if the landlord accepts the repudiation, its damages are fixed and it may immediately attempt to relet the premises.

The BIA, by framing the issue as one of repudiation however, appears to give the landlord the option of not accepting the repudiation and insisting on the performance by the debtor of the obligations in the lease. The danger in taking this course of action is that the lease also remains in effect for the benefit of the debtor who may continue to occupy the demised premises and insist on its rights under the lease. Because the BIA limits the quantum of damages and gives the debtor the right to "unilaterally repudiate" the lease, it seems inconceivable that a landlord would not want to accept the repudiation and, at least, attempt to relet the premises to gain the "windfall" of two sources of rent from the premises for the same period.

The remedy of specific performance should not be available to a landlord, as it not only is contrary to the express wording of the BIA, which allows the debtor to "repudiate" the lease, but also, if granted, could result in the landlord receiving a claim in excess of its entitlement under the provision of the BIA.

On the commencement of a proceeding under the Code, an unexpired nonresidential real property lease becomes part of the debtor's estate. Subsection 365(a) of the Code entitles the trustee
to "reject" an unexpired lease of the debtor. It provides:

Except as provided in . . . subsection (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.

Anglo-American law has no definition for the concept of "rejection" of a contract. Accordingly, American courts have described rejection as a release, repeal, voiding, cancellation, reconsideration, discharge, revocation, repudiation, alteration or avoidance of the lease. The Code describes the consequences of rejection of an unexpired lease as a breach of the lease "immediately before the date of the filing of the petition" if the lease "has not been assumed" under section 365 or under the plan of arrangement. This determines the period during which the landlord may claim damages for breach of the lease. Unlike the concept of repudiation, no question arises as to the acceptance or nonacceptance of the rejection, with the attendant problems of quantification of damages and possibility of remedies such as specific performance. One commentator suggested that it is improper to characterize rejection as revocation, repudiation or cancellation of the lease but simply, rejection is a

debtor's bankruptcy but the trustee was required to make an affirmative decision to assume the lease to bring the lease into the estate. See e.g. In re Lovitt, 757 F.2d 1035 (9th Cir. 1985). Although this case was decided after the passage of the Code, the decision was based on pre-Code law as the bankruptcy proceeding was commenced five years prior to the passage of the Code. The rationale underlying this decision was that the estate should not be responsible for the liabilities of an unexpired lease until such time as the trustee has an opportunity to consider whether the estate will benefit from it [at 1041]. Although M.T. Andrew, "Executory Contracts in Bankruptcy: Understanding 'Rejection'" (1988) U. Colo. L. Rev. 845 at 860-866, suggests that this is the current position in the United States, the Code makes the debtor's interest in an unexpired nonresidential lease, property of the estate. Paragraph 541(a)(1) of the Code includes, as property of the estate, "all legal or equitable interests of the debtor in property as of the commencement of the case." Specifically excluded from the estate is, inter alia, the debtor's interest as lessee under a lease of nonresidential real property that has expired by virtue of its own terms. The specific exclusion, suggests that a lease which has not expired by its own terms is included as part of the estate and therefore, the cases decided under the 1898 U.S. Act are inapplicable to the Code. See e.g., Re Convenient Food Mart No. 144, Inc., 968 F.2d 592 (6th Cir. 1992); Re Arizona Appetito's Stores, Inc., 893 F.2d 216 (9th Cir. 1990); cf Turner v. Avery, 947 F.2d 772 at 774 (5th Cir. 1991), where the court held that "an executory contract becomes part of the bankruptcy estate when the contract is assumed by the trustee." [emphasis added].

294 Andrew, ibid. at 847.

295 Ibid [citations omitted].

296 Code s. 365(g).
decision not to assume. Rejection does not affect liabilities under the lease, which continue, but the Code quantifies the landlord's damages and limits its remedies.

By using "rejection," which is a concept unknown to contract law, it appears that Congress intended to provide the courts with an opportunity to fashion remedies, unencumbered by prior jurisprudence, which the courts could seize upon to frustrate Congressional intent. However, by analogizing rejection to concepts such as repudiation or revocation, the American courts allow the "conceptual baggage" to follow the previously unknown concept. As it is difficult to resist the temptation to equate "rejection" with familiar concepts, perhaps the approach taken in the BIA is preferable, viz., using a familiar concept having certain fundamental attributes. However, the concept of repudiation may not be the most appropriate, as it may cause the parties to inadvertently act in a manner detrimental to their interests and give the other party rights that were not intended.

Although it is not the intention of this paper to conduct a detailed examination of models other than the BIA, the CCAA and the Code, the Insolvency Act 1986 (U.K.) may provide a useful model for the purposes of this discussion. Section 315 of the U.K. Act allows the trustee to "disclaim any onerous property." The concept of disclaimer has been described as "a renunciation of, or refusal to claim, rights or property which would automatically devolve on or accrue to the person making the disclaimer" or, more simply,

A disclaimer, to be worth anything, must be an act whereby one entitled to an estate immediately and before dealing with it renounces it; whereby, in effect, he says, "I will not be the owner of this property." The U.K. Act does not require the trustee to disclaim the onerous property before "dealing with the

297 Andrew, supra note 293 at 848.
298 1986, c. 45 [hereinafter the U.K. Act].
299 In re Lister, [1926] 1 Ch. 149 at 165 (C.A.). See also In re Fussell; ex p. Allen (1882), 20 Ch. D. 341 at 346 (C.A.) where the court described the trustee's right to disclaim as a right "to get rid of the property".
300 Bence v. Gilpin (1868), L.R. 3 Ex. 76 at 81.
property” but gives the trustee a period of time within which to make that decision. It also entitles the trustee to disclaim the onerous property even though the trustee has exercised rights of ownership, attempted to sell or taken possession of the property. The essence of the concept, however, is that once disclaimed, the trustee may take none of the benefits of the lease and will not be responsible for any of its burdens. That is, notionally, the lease never becomes part of the bankrupt's estate and the landlord may file an unsecured claim for damages. Unlike repudiation, the landlord has no option or obligation to accept or reject the disclaimer. The disclaimer, ipso facto, extinguishes any liability of the trustee and the estate upon the lease.

301 U.K. Act ss. 315(1), 316 and 317.

302 U.K. Act s. 315(3) sets forth the effect of the disclaimer and the respective rights of the parties as follows:

(3) A disclaimer under this section -
(a) operates so as to determine, as from the date of the disclaimer, the rights, interests and liabilities of the bankrupt and his estate in or in respect of the property disclaimed, and
(b) discharges the trustee from all personal liability in respect of that property as from the commencement of his trusteeship,
but does not, except so far as is necessary for the purpose of releasing the bankrupt, the bankrupt's estate and the trustee from any liability, affect the rights or liabilities of any other person.


304 Re Salok Hotel Co. Ltd. (1968), 11 C.B.R. (N.S.) 95 at 101 (Man. Q.B.). The U.K. Act does not, however, affect the rights or liabilities of any other person [U.K. Act s. 315(3)] and allows any person suffering a loss as a result of the disclaimer to prove that loss in the bankruptcy proceeding [U.K. Act s. 315(5)]. Although this would give the landlord and others an opportunity to attempt to recover their losses in the bankruptcy proceeding, the primary benefit is that it does not extinguish the "rights or liabilities" of any other person. For example, a landlord could continue any action against a guarantor of the obligations of the tenant under the lease. Cf. Cummer-Yonge Investments Limited v. Fogot (1966), 8 C.B.R. (N.S.) 62 (Ont. S.C.) where the court held that a disclaimer by the trustee extinguished all of the rights and obligations under the lease, including the covenant to pay rent. Accordingly, the liability of the guarantors was similarly extinguished. It should also be noted that determination of rights and liabilities under the lease only takes effect from the date of the disclaimer. Accordingly, it would appear that the trustee would be personally liable for occupation rent and other charges arising under the lease during the period between the appointment of the trustee and the effective date of the disclaimer. See e.g., In re Lister, supra note 299.
The concept of disclaimer more accurately reflects the result intended by the drafters of section 65.2 of the BIA. Upon a "repudiation" of the lease by the insolvent person, the BIA does not require the landlord to accept or reject the repudiation but compensation is payable to the landlord because of the "repudiation." The statutory compensation is not a preestimate of common law damages. It is statutory compensation and accordingly, it does not require a doctrinal foundation, such as damages resulting from a breach of the lease.

A debtor, following its giving notice to the landlord advising of the repudiation, could not contend that, as the landlord did not accept the repudiation, the lease thereafter subsists. Once the debtor gives notice to the landlord, it makes an election. From the effective time of the notice of repudiation, the right of the debtor to remain in occupation of the demised premises and to claim a leasehold title is extinguished. Disclaimer accomplishes this result and use of the concept of repudiation merely implies that there are other rights and obligations on the parties that the policymakers did not intend. Accordingly, to avert the possibility of a party attempting to rely on those rights, the policymakers should expunge the concept of repudiation and replace it with the more clearly delineated concept of disclaimer.

Similarly, the American notion of rejection, although providing the courts with flexibility to attach certain attributes to it, merely allows the courts to attempt to equate it with existing legal concepts. Accordingly, American policymakers should discontinue any use of this term.

Rather than attempting to fashion a new legal concept or using a concept that derogates from the intended result, the policymakers should use "disclaimer" which is a concept with a fixed legal meaning and accomplishes the intended objectives, viz., the termination of the landlord and tenant relationship, on certain conditions such as the preservation of certain rights of the parties to the lease

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305 The drafters of the BIA do not appear to be averse to the concept of disclaimer as it is used in relation to a trustee disclaiming a lease of property of the bankrupt in a liquidation scenario [BIA s. 30(1)(k)].

306 See e.g., supra note 295 and accompanying text.
and third parties. In Canada, the termination of the landlord and tenant relationship could occur within a fixed time after the giving of the notice, unless the landlord applies to avert the termination. The balance of the section could apply mutatis mutandis.

3. Rejection or Repudiation of Unexpired Leases to Facilitate Reorganization

This subsection will review the provisions that allow a debtor leasing nonresidential real property to reject or repudiate an unexpired lease. Rather than simply reviewing the provisions of the Code, the BIA and the CCAA in isolation, a more useful methodology will be to compare certain features of the proceeding leading up to, and the consequences of, a rejection or repudiation. This comparative method will assist us in arriving at a useful model for reform or, at least, identify matters that should be considered in attempting to formulate reforms.

The right to assume or reject an unexpired lease is a unique and powerful tool under all of the legislative schemes. Although this tool is available to the trustee or the debtor in possession once the reorganization proceeding is commenced, it was not available to the debtor before commencement of the proceeding. In this way, the trustee or debtor in possession is in a stronger position than that of the debtor prior to the commencement of the proceeding. The right to assume or reject an unexpired lease is consistent with the policy of encouraging the rehabilitation of the debtor.

307 See e.g., W.E. Winfield, "Rejection of Nonresidential Leases of Real Property in Bankruptcy: What Happens to the Mortgagee's Interest?" (1989/90) 17 Pepperdine L. Rev. 429, where the author discusses how the characterization of rejection as a termination or breach may result in differing effects on a mortgage of the leasehold interest.

308 BIA s. 65.2(2).

309 Notwithstanding the discussion in chapter V(B)(2), above, this section will use the statutory terminology. That is, when discussing the Code, the term "rejection" will be used. When discussing the BIA or the CCAA, the term "repudiation" will be used. However, as it has been argued that the term "disclaimer" more accurately conveys the legislative intent, the terms are referred to in that context.

310 House Report at 174-175, 220-221.
(a) The Necessity for the Existence of a Lease

For the provisions allowing the rejection or repudiation of a lease to be operative, there must be a lease in existence. Under the Code, the lease must be "unexpired" at the time the petition is filed and, if expired, the petition does not resurrect the lease.311 If the term of the lease has expired or if the parties have terminated it before the commencement of the case, there is nothing for the trustee to reject or assume.312 This is consistent with subsection 541(a) of the Code that includes, as part of the estate, the debtor's interests in property "as of the commencement of the case" and paragraph 541(b)(2) which specifically excludes the leasehold interest of a debtor whose stated term has expired before the commencement of the case.313

State law determines whether the lease expired prior to the filing of the petition,314 and the courts have used state law to prevent prepetition termination. For example, the court may exercise its equitable power to relieve against forfeiture of the interest of the debtor,315 or hold that the landlord has waived or is estopped from relying on its right to terminate the lease.316 Having a lease in existence at the commencement of the case has some importance. Even if the debtor ultimately rejects it, the trustee must have an opportunity to determine whether the estate would benefit from the lease and, as a practical matter, may require premises from which to operate pending formulation of the plan


313 Supra note 293.


315 See e.g., In re Fountainbleau Hotel Corporation, 515 F.2d 913 at 914 (5th Cir. 1975); but see Mimi's of Atlanta, Inc., 5 B.R. 623 (Bankr. N.D. Ga. 1980), where the court stated that "... equitable considerations... should be drawn upon by bankruptcy courts only in rare instances..." [at 628].

of arrangement.\textsuperscript{317}

Assumption of an unexpired lease subjects the estate not only to the benefits but also to the burdens.\textsuperscript{318} The converse is also true and is consistent with the English doctrine of disclaimer which holds that if the trustee disclaims a contract, the trustee may not disclaim the detriment and retain the benefit.\textsuperscript{319} If the lease, once assumed by the trustee under the Code, expires or terminates by its terms, the expiry or termination is binding on the trustee, who cannot thereafter seek to amend the lease.\textsuperscript{320} Conversely, once the trustee rejects the unexpired lease, the rejection is binding on the estate and the rejection permanently deprives the estate of any benefit that may thereafter accrue under the lease.\textsuperscript{321}

Section 65.2 of the BIA allows the repudiation of "a lease of real property" which presupposes the existence of a lease. In a liquidation proceeding, the court will uphold the forfeiture of the term before bankruptcy and the trustee will therefore have nothing to retain or disclaim.\textsuperscript{322} Provincial law determines whether a lease term has expired before the commencement of proposal proceedings.\textsuperscript{323}

The courts do not appear to have dealt with the issue of whether a lease must be in existence at the time of the initial application pursuant to the CCAA. However, given that this paper is dealing with the rejection or disclaimer of a lease and that the courts in a CCAA proceeding are not inclined

\textsuperscript{317} It is acknowledged that this is not a cogent reason for allowing the trustee to remain in possession of the demised premises and a trustee would not attempt to use this as the sole basis for argument. However, it is merely given as an illustration of the practical considerations which may be behind a request for the court to exercise its equitable jurisdiction to disallow the termination.

\textsuperscript{318} In re TSW Stores of Nanuet, Inc., 34 B.R. 299 at 304-306 (Bankr. S.D.N.Y. 1983).

\textsuperscript{319} In re Fussell, ex p. Allen, supra note 405; and see In re TSW Stores of Nanuet, Inc., ibid.; In re Pin Oaks Apartments, 7 B.R. 364 at 369-370 (Bankr. S.D. Tex. 1980).

\textsuperscript{320} In re Pin Oaks Apartments, ibid. at 372; In re Nashville White Trucks, Inc., 5 B.R. 112 at 116-117 (Bankr. M.D. Tenn. 1980).


\textsuperscript{323} Re Custom Cresting Ltd. (1975), 19 C.B.R. (N.S.) 282 (Ont. S.C.).
to award substantial damages or compensation for a rejected lease, this is an issue which is not significant.

(b) *Ipso Facto* or Bankruptcy Clauses

Section 70b of the 1898 U.S. Act expressly sanctioned the operation of "bankruptcy clauses" or "*ipso facto* clauses," which allow a landlord to terminate a lease based solely on the bankruptcy of the tenant.\(^{324}\) These clauses severely restricted the trustee's right to assume and assign leases and hampered the debtor's capacity to effect a reorganization.\(^{325}\) On the other hand, by invoking an *ipso facto* clause, a landlord could avoid involvement in the debtor's bankruptcy proceedings and retain control over selection of a tenant that would ultimately occupy the premises. The bankruptcy courts, pursuant to their equitable jurisdiction, had an aversion to forfeiture and accordingly, even in the face of the legislative sanction, the courts granted relief from forfeiture by holding that *ipso facto* clauses were penalties or that landlords either waived or were estopped from relying on them.\(^{326}\) The courts considered not only the interests of the tenant and the landlord but also the interests of other creditors.\(^{327}\)

\(^{324}\) 1898 U.S. Act s. 70b, *inter alia*, provided that "... an express covenant that ... the bankruptcy of a specified party thereto or of either party shall terminate the lease or give the other party an election to terminate the same shall be enforceable."

\(^{325}\) House Report at 348 and Senate Report at 59.

\(^{326}\) See *e.g.*, *Geraghty v. Kiami Fifth Avenue Corp.*, 210 F.2d 95 (2d Cir. 1954).

\(^{327}\) See *e.g.*, *Queen's Boulevard Wine & Liquor v. Blum*, 503 F.2d 202 (2d Cir. 1974), where it appears that one of the factors which the court found particularly repugnant was the fact that, if the termination of the lease were allowed to stand, the landlord would receive a windfall as it would undoubtedly be in a position to lease the premises at a rental rate higher than was being paid by the debtor/tenant. However, the converse is also true. That is, if the lease was advantageous to the tenant, the trustee could assume the lease and take the benefit of the lease at the reduced rate or seek to assign it for somewhere between the agreed upon rate and the market rate. While it is acknowledged that the landlord would retain what it bargained for (ie. the reduced rate), the court was making a choice between the interests of the landlord and those of the tenant and simply chose to favour the interests of the tenant and those of the other creditors, who would benefit from the assignment. However, the prospect of a windfall is not the sole factor motivating landlords. Perhaps more important is the nature and character of the proposed assignee, not only in relation to its financial
Subsection 365(e) of the Code makes the effect of *ipso facto* clauses unenforceable.\(^{328}\) It disallows the termination or modification of a lease solely because of the insolvency or financial condition of the debtor, the commencement of a case under the Code or the appointment of a bankruptcy trustee or custodian. The legislative history indicates that Congress inserted this provision to avert the detrimental effects of these clauses on the debtor's rehabilitation efforts.\(^{329}\) At the same time, the Senate Report and House Report\(^{330}\) instructed the courts to be sensitive of the rights of landlords.

The automatic stay of proceedings\(^{331}\) also prevents the landlord from taking any proceedings to condition but also in maintaining the existing tenant mix. For example, a discount clearance store could hardly fit within the plans of the landlord if the intent of the project was to only have high end fashion stores as tenants.

\(^{328}\) The courts have held that this provision does not violate the prohibition against taking property without due process of law embodied in the Fifth Amendment. See *In re Sapolin Paints, Inc.*, 5 B.R. 412 (E.D.N.Y. 1980), where the court stated:

"In refusing to [allow the landlord to terminate the lease on] the mere filing of a petition for relief under the bankruptcy laws, and by laying down as a rule of law that a landlord who is otherwise receiving, and will receive, full performance under his lease, may not declare a forfeiture, Congress has not exceeded its constitutional powers." [at 423-424]

See also, *In re National Shoes, Inc.*, 20 B.R. 55 (Bankr. S.D.N.Y. 1982); cf. *In re LJP, Inc.*, 22 B.R. 556 (Bankr. S.D. Fla. 1982), where the court held that subsection 365(e) of the Code was not intended to prohibit termination of a contract prior to the commencement of the case, solely on the basis of the insolvency of the debtor.

\(^{329}\) House Report at 348; Senate Report at 59.


\(^{331}\) Code s. 362. By virtue of the 1984 Amendments however, the automatic stay of proceedings does not stay:

"... any act of the lessor to the debtor under a lease of nonresidential real property that has terminated by the expiration of the sated term of the lease before the commencement of or during a case under this title to obtain possession of such property;" [Code s. 362(b)(10)].

The legislative history indicates that this provision merely attempted to clarify the position that as the interest of the debtor had expired prior to the commencement of the case, such interest did not form a part of the estate and accordingly, the landlord could immediately take steps to repossess and lease the property [*Senate Report No. 65, 98th Cong., 1st Sess. 68 (1983) reprinted in Norton Bankruptcy Code Pamphlet 1993-1994 Edition 234*]
terminate the lease or recover the demised premises. As such, the landlord is at the mercy of the trustee during the initial stages of the case, notwithstanding the possible vacancy of the demised premises and the effect that the vacancy may have on other tenants.332

In Canada, the effect of an *ipso facto* clause appears to vary from province to province333 in liquidation proceedings. Prior to the BIA, if a lease contained a forfeiture provision that became operative if the lessee took advantage of any act for the benefit of insolvent debtors, the courts upheld the forfeiture on the filing of a proposal.334 Section 65.1(1) of the BIA, prohibits termination or amendment of the lease after the lessee commences proposal proceedings. Termination or amendment of the lease prior to the filing remains enforceable. This is not unlike the situation under the Code where the courts prohibit reliance on an *ipso facto* clause after commencement of the case but allow landlords to terminate leases based on such a clause prior to commencement.335

The provisions prohibiting the enforceability of *ipso facto* clauses attempt to balance the interests of landlords and debtors. Clearly, landlords suffer prejudice by not being able to rely on

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333 E.g., the *Commercial Tenancy Act*, R.S.B.C. 1979, c. 54 appears to allow the effect of *ipso facto* clauses. Subsection 32(3) reads, in part as follows:

"(3) If the lessee is a tenant of premises the tenancy of which is not determined by the making of a receiving order or assignment . . . [the trustee may surrender or assign the lease]."

However, the Ontario *Landlord and Tenant Act*, R.S.O. 1990, c. L.7, s. 38(2) provides:

"(2) Despite any provision, stipulation or agreement in any lease or agreement or the legal effect thereof, in the case of an assignment for the general benefit of creditors, or an order being made for the winding up of an incorporated company, or where a receiving order in bankruptcy or authorized assignment has been made by or against a tenant, . . . [the trustee may retain or disclaim the lease]."

334 *Re McKay* (1921), 2 C.B.R. 59 (Ont. S.C.); cf. *Drozdziński v. Zemel* (1953-54) 34 C.B.R. 59 (Que. S.C.), where the court held that since a court approved proposal is binding on all creditors, "the purpose of the Bankruptcy Act would be frustrated if the [landlord] were permitted to exercise the [ipso facto] clause which he now seeks to enforce." [at 60].

335 *In re LJP, Inc. supra* note 328.
these clauses to retain some control over their premises. The effect, however, is less prejudicial to
Canadian landlords, as the choices open to the debtor following the commencement of proposal
proceedings are limited. The debtor may retain the lease, in which case all of the provisions are
applicable, including any restriction on assignability, or it may reject the lease, in which case the
landlord is free to relet the premises to a tenant of its choice. In the United States, the landlord faces
a third possibility. A trustee may assume the lease and assign it to a third party, despite a restriction
on assignment contained in the lease. This allows the trustee to take the benefit of a favourable
lease for the estate.

Whether Canadian policymakers should adopt the third option, which is available in the United
States, is not a question that we may answer in isolation. The answer is determined by examining
whether the policymakers seek to encourage reorganizations. The American system allows the trustee
to assign an advantageous lease that is unnecessary to the continuing operations of the reorganized
debtor and to use the funds received or to be received for ongoing operations. This clearly
encourages reorganizations. In the Canadian system, a favourable but unwanted lease is of limited
value to the debtor, because of the absence of the third option. If the debtor repudiates the lease, the
landlord will receive the financial benefit of the buoyant market. If, however, the debtor retains the
lease, it must continue to abide by the lease terms, which may be a drain on working capital. It
cannot take advantage of the opportunity to increase cash flow unless the lease itself permits
assignment.

336 Code s. 365(b)(3). There are certain conditions on assumption and assignment of all leases
(Code s. 365(b)) and additional conditions if the demised premises are located in a shopping centre
(Code s. 365((b)(3)). A discussion of these provisions is beyond the scope of this paper.

337 See e.g., Sapolin Paints, Inc., supra note 328, where the debtor in possession was in a position
to dispose of its leasehold interest for $230,000.
(c) Time Limit for Election to Reject or Repudiate

In requiring the courts to be sensitive to the rights of landlords, the Senate Report stated:

If the trustee is to assume a contract or lease, the court must ensure that the trustee's performance under the contract or lease gives the other contracting party the full benefit of his bargain.338

This proposition raises the question of whether, if the trustee rejects the unexpired lease, the landlord is entitled to the full benefit of its bargain during the period between the commencement of the case and the ultimate rejection of the lease. In other words, is the landlord entitled to "adequate protection" during that period? There are two aspects to this problem. The first involves the issue of the timing of the election. The second is that, by virtue of a requirement in the Code or because of its obligations to other tenants, the landlord is required to provide services and supplies incidental to the lease.339

Before the enactment of the 1984 Amendments, the Code did not obligate the trustee to make an election to assume or reject an unexpired lease in a reorganization proceeding within a prescribed time. The only requirement was that the trustee had to make the election prior to confirmation of the plan.340 The courts, however, imposed a requirement that the trustee had to make the election within a reasonable period following the commencement of the case, depending on the facts of each case.341

The protracted period taken by trustees in making the election and the uncertainty of the duration of a "reasonable time" resulted in a strong lobby of shopping centre associations precipitating the 1984 Amendments.342 The 1984 Amendments resulted in a change to paragraph 365(d)(4) which now

338 Senate Report at 59.

339 See discussion chapter V(B)(3)(d), below.


341 Theatre Holding Corp. v. Mauro, 681 F.2d 102 (2d Cir. 1982).

requires the trustee to make the election within a period of 60 days after the date of the order for relief or within such additional time as the court fixes. If the trustee fails to assume the lease within that period, the Code deems the lease rejected.\textsuperscript{343}

Despite the imposition of a time limit, the courts again exhibit their aversion to forfeiture of the leasehold interest through application of the doctrines of waiver\textsuperscript{344} and estoppel.\textsuperscript{345} Even if the courts interpreted the 60-day period strictly, this may be an inordinate period for the lessor to have vacant premises or a nonperforming tenant.\textsuperscript{346}

The BIA does not provide a specific time within which the debtor must repudiate the lease. To repudiate, however, the debtor must provide 30 days notice to the landlord.\textsuperscript{347} The courts have

\textsuperscript{343} Paragraph 365(d)(4) has been called "self-executing" given that rejection of the lease occurs automatically at the end of the sixty-day period without the need for court approval [\textit{In re Simpson}, [1994] Bankr. LEXIS No. 431 (Bankr. W.D. Okla. March 25, 1994)].

A significant body of case law has developed concerning the extent of the obligations of a trustee during the sixty-day period in order to assume the lease. In particular, those cases are concerned with the issue of whether the court approval for the assumption or for an extension period must be given within the sixty-day period or whether the mere filing of a motion within that period will suffice. As this paper is concerned with the rejection of unexpired leases, a full discussion of this matter will not be undertaken. However, the reader is referred to Sabino and Susca, \textit{ibid} for a discussion of this matter.

\textsuperscript{344} See \textit{e.g.}, \textit{In re T.F.P. Resources}, 56 B.R. 112 (Bankr. S.D.N.Y. 1985), where the court held that the lessor waived its rights to strict enforcement of the time limitation in paragraph 365(d)(4) of the Code by continuing to accept rent payments following the expiration of the 60-day period.

\textsuperscript{345} See \textit{e.g.}, \textit{In re Haute Cuisine, Inc.}, 57 B.R. 200 (Bankr. M.D. Fla. 1986), where the court held that the lessor's actions resulted in the debtor not complying with its duty to obtain court approval. The lessor could not take advantage of the debtor's detrimental reliance and was therefore estopped from being in a position to rely on its strict rights. See also \textit{In re Ranch House of Orange-Brevard Inc.}, 773 F.2d 1166 (11th Cir. 1985).

\textsuperscript{346} \textit{Cf. In re Haute Cuisine, Inc.}, \textit{ibid} at 202, where the court noted that "sixty days may be an insufficient amount of time for the debtor-in-possession or trustee to make an informed decision on whether to assume or reject an unexpired lease." and \textit{In re American Healthcare Management, Inc.}, 900 F.2d 827 at 830 (5th Cir. 1990), where the court confirmed that the primary purpose of paragraph 365(d)(4) is "to protect lessors . . . from delay and uncertainty by forcing a trustee or a debtor in possession to decide quickly whether to assume unexpired leases." [citations omitted].

\textsuperscript{347} BIA s. 65.2(1).
held that this 30-day period is the minimum notice required to repudiate the lease.348 The maximum time within which the debtor must elect to repudiate is the time available to the debtor to file the proposal itself, which could be up to 7 months.349

The CCAA does not prescribe a period within which the debtor must formulate and complete the plan of arrangement. However, courts have generally been reluctant to allow the process to go on \textit{ad infinitum} and they tend to follow the proceedings very closely by allowing interlocutory motions on short notice.350

\footnote{Janpar, \textit{supra} note 264 at 10.}

348 Should the debtor choose to file a proposal in the first instance, a meeting of creditors must be held within 21 days after the proposal is filed [BIA s. 51]. Within five days after approval by the creditors, the trustee must apply for the court's approval, giving at least fourteen days notice of the hearing. If the proposal is approved by the court, payment to the landlord of the statutory compensation must be made "immediately" [BIA s. 60(1.5)]. In this case, the debtor must effectively make the decision concerning the repudiation of leases prior to the filing of the proposal, as the proposal must provide for repudiation and the compensation. However, the actual repudiation may not take effect until after the court approves the proposal.

Where the debtor chooses to file a notice of intention to file a proposal, however, the decision-making period is extended inasmuch as the debtor is not required to file the actual proposal until 30 days after the filing of the notice of intention [BIA s. 50.4(8)] or "within any extension of that period". Subsection 50.4(9) allows the court to grant extensions to the debtor of the time within which the proposal must be filed. Each extension period is not to exceed 45 days and the aggregate of all extension periods shall not exceed 5 months, after the expiration of the initial 30-day period. In other words, the debtor could have a total of 6 months to formulate the proposal. Should the proposal and notice of repudiation contemplate repudiation immediately following court approval, the landlord could potentially be waiting in excess of 7 months before it obtains vacant possession of the premises. This assumes the following time periods:

\begin{itemize}
  \item 180 days - maximum time to file proposal after filing notice of intention
  \item 21 days - maximum time for the holding of the meeting
  \item 5 days - maximum time within which to apply to the court for court approval
  \item 14 days - minimum time for the giving of the notice of hearing
  \item 220 days
\end{itemize}

This period could be even longer if the debtor chose to give extended notice of the hearing.

\footnote{See \textit{e.g.}, Re \textit{Northland Properties Ltd.} (1988), 73 C.B.R. (N.S.) 171 (B.C.S.C.), where the court exhibited its reluctance to grant an adjournment of the date for the meeting to consider the plan of arrangement by stating:

"With some hesitation, I have concluded a refusal to grant some further time is less desirable than granting an adjournment. I am not unmindful of the history of these proceedings and what appears to be an attempt to use the system to its utmost to avoid obligations that the}
(e) Performance of Obligations During the Stay of Proceedings

Paragraph 365(d)(3) provides:

The trustee shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under an unexpired lease of nonresidential real property, until such lease is assumed or rejected . . . The court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period . . . Acceptance of any such performance does not constitute waiver or relinquishment of the lessor's rights under such lease or under this title.

In other words, by the time that the 60-day period has elapsed, the trustee should have fulfilled all of the debtor's obligations which arose during that period, strictly in accordance with the lease.\(^{351}\) There are two difficulties with paragraph 365(d)(3). First, no sanction is imposed for noncompliance. The Code does not provide for a deemed rejection of the lease or personal liability of the trustee for failure to fulfil the debtor's obligations. The availability of the latter remedy has been effective in Canadian bankruptcy proceedings. The problem with attempting to impose such liability in an American proceeding is that, usually, a trustee is not administering the reorganization proceeding. Instead, the debtor in possession is usually controlling the business. In such a case, perhaps some type of security would allay the concerns of the landlords.

The second difficulty with paragraph 365(d)(3) arises out of paragraph 365(b)(4) which

petitioners have to their creditors. However, having proceeded to this stage, in my view it is preferable that a proposal should take place if at all possible." [at 172-173]

See \textit{e.g.}, the proceedings involving Quintette Coal Limited, where the court allowed the debtor a period of 6 months within which to file its plan of arrangement. Although the creditors felt this to be an inordinate amount of time, it should be noted that ultimately, the plan of arrangement was not actually approved by the court until almost 2 years after the proceedings were commenced, one must be cognizant of the fact that this case was a multinational reorganization involving a substantial amount of money. The amount owed to creditors at the commencement of the proceeding was approximately \$761,000,000. See generally, D.F. Tysoe, "Quintette Coal Limited: Chronology of Companies' Creditors Arrangement Act Proceedings" in \textit{The Insolvency Institute of Canada Second Annual Meeting and Conference Materials} (Orillia: October 20-22, 1991).

\(^{351}\) See \textit{In re Wingspread Corp.}, 116 B.R. 915 (Bankr. S.D.N.Y. 1990); \textit{In re Fisher}, 51 B.R. 680 (Bankr. S.D. Oh. 1985); \textit{cf. In re Orvco}, 95 B.R. 724 (Bankr. 9th Cir. 1989), where the court held that the lessor is required to establish the quantum of its claim, rather than using the rates set forth in the lease.
Notwithstanding any other provision of this section, if there has been a default in an unexpired lease of the debtor, . . . the trustee may not require a lessor to provide services or supplies incidental to such lease before assumption of such lease unless the lessor is compensated under the terms of such lease for any services and supplies provided under such lease before assumption of such lease. [Emphasis added]

Read with paragraph 365(d)(3), this paragraph suggests that if there has been no default in the lease, the trustee may require the landlord to provide services and supplies prior to the exercise of the election to assume or reject, provided the landlord receives payment for such services on an ongoing basis or within the 60-day period, if the court has granted that order.352 In other words, the landlord must provide services and supplies without receiving current payment and because there is no legislative sanction for nonpayment, the landlord is at risk that payment may not be forthcoming at all. Furthermore, the landlord, besides being required to provide services and supplies to the trustee with respect to the demised premises in question, must provide services that would otherwise be common costs recoverable under the lease, such as security, parking, snow removal, heating, ventilation, air conditioning and the like. This will result in other tenants having to bear a proportion of those costs.353

With this background, we now discuss the question of the landlord's entitlement to adequate protection during the period between the order for relief and the election to assume or reject the unexpired lease. Subsection 362(a) of the Code imposes an automatic stay of proceedings against a

352 See In re Monarch Capital Corporation [1994] LEXIS No. 124 at 21-22 (Bankr. D. Mass. February 8, 1994). In fact, it has been said that the main purpose of section 365 of the Code is:

"... to allow a debtor to reject executory contracts in order to relieve the estate of burdensome obligations while at the same time providing a means whereby a debtor can force others to continue to do business with it when the bankruptcy filing might otherwise make them reluctant to do so." [In re Chateaugay Corporation, 10 F.3d 944 at 954-955 (2d Cir. 1993) quoting In re Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303 at 1360 (5th Cir. 1985)].

353 The foregoing discussion is based on the writer's knowledge of commercial lease transactions in Canada. Whether the results suggested actually happen in the United States is based solely on conjecture.
landlord seeking to recover unpaid charges and attempting to terminate the lease based on prepetition defaults. The concept of adequate protection applies to the use, sale or lease of property. The courts are not in agreement as to whether adequate protection is available to landlords. They have taken three different approaches to the issue. The first is an approach not adopted by the courts in relation to real property leases but used in relation to other executory contracts. In National Labor Relations Board v. Bildisco and Bildisco, the United States Supreme Court held that subsection 362(a) of the Code did not stay the rights of the nondebtor party. Rather, the rights of the nondebtor party were temporarily unenforceable. The remedy of the third party would not be relief from the automatic stay pursuant to subsection 362(d), but the remedies pursuant to section 365 and 503(b)(1), which provide an administrative expense priority for the actual and necessary costs and expenses of preserving the estate. In a situation involving a real property lease, the landlord would seek to recover the costs of services and supplies from the estate in priority to unsecured creditors. This approach does not satisfactorily resolve the issue. Commencement of the case does not render all rights of the landlord temporarily unenforceable. Section 365 specifically provides that certain provisions of the lease remain enforceable. It is the stay of proceedings that prevents the landlord from exercising all of its rights under the lease. To exercise those rights, the landlord must seek relief from the stay.

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355 For a discussion of the concept of adequate protection, see chapter V(A)(1)(b), above.

356 Code s. 363(e) provides:

(e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.


359 E.g., Code s. 365(c)(3).
Should the court deny the relief, the landlord is entitled to have its interest adequately protected under subsection 362(d) or 363(e).

*In re Sweetwater* illustrates the second approach. In that case, the court refused to award adequate protection based on the legislative history. Before the passage of the Code, earlier bills provided that adequate protection would be available to both secured creditors and to landlords. However ultimately, the Code provided separate forms of protection for secured creditors in sections 361 and 363(e) and for lessors in section 365. The portions of the House Report and the Senate Report discussing section 361 do not mention landlords, only secured creditors. Commentators have criticized this approach on the ground that it breaches the fundamental principle of statutory interpretation that the court need not go beyond the plain and unambiguous wording of the statute if the language admits only one meaning. However, subsequent cases have followed *Sweetwater*.

*In re DeSantis* illustrates the final approach. In that case, the court awarded adequate protection to the landlord based on the plain meaning of subsection 363(e). The court held that the requirement of timely performance of the obligations imposed by the lease pursuant to paragraph 365(d)(3) was merely a component of adequate protection. Because of paragraph 362(b)(10), which

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364 See e.g., *In re Cafe Partners/Washington 1983*, 81 B.R. 175 (Bankr. D.D.C. 1988), where the court held:

"[A]s a matter of law under Section 365, a non-debtor landlord is not entitled to interim 'adequate protection'. Nor, as a corollary to that principle, is a non-debtor landlord entitled to relief from the automatic stay imposed by Section 362(a) in the absence of 'adequate' protection. Rather, the exclusive remedies for the landlord are found in Section 365." [at 180].


provides that the commencement of a bankruptcy case does not result in an automatic stay being imposed against landlords whose leases have expired prior to the commencement of the case, the stay binds other landlords. Those landlords cannot be limited to section 365 for their remedies as it:

... would mean that a lessor is effectively stayed upon the filing of the bankruptcy petition but the lessor cannot obtain relief from the stay when the trustee utilizes the leasehold under section 363 without adequate protection or when the trustee fails to comply with the lease term as required by section 365(d)(3).

Although it has been suggested that "given the need for flexibility in modern sophisticated transactions, adequate protection must be available in conjunction with section 365," a better solution would be to provide a more effective method of enforcing paragraph 365(d)(3) through the requirement of security or the imposition of personal liability for breach. In most cases, if the debtor ultimately rejects the lease, the landlord is looking for no more than occupation rent, as defined in the lease, which would include operating costs as additional rent. The landlord is entitled to be adequately protected for the amount of occupation rent and failure to provide that protection should result in an immediate deemed rejection of the lease.

Under the BIA, during the period between commencement of the proposal proceedings and court approval of the proposal, the landlord may not terminate or amend the lease on the basis only of the insolvency of the debtor. Furthermore, by virtue of the stay of proceedings, the landlord may not commence or continue any action, execution or other proceeding for the recovery of its claim. If there is a breach of the lease during the interim period which is not based on the solvency of the

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367 Ibid. at 1001.
368 Ibid.
369 Schorling and Simons, supra note 363 at 314.
370 The landlord's claim for other amounts such as accelerated rent is unsecured and accordingly, adequate protection of such amounts is unnecessary.
371 BIA s. 65.1(1).
372 BIA s. 69.1.
debtor, the landlord may be able to argue that it is in a position to terminate the lease. The prohibition on termination applies only to the insolvency of the debtor and the failure to pay rent "prior to" the commencement of the proceeding. However, because the stay of proceedings applies to judicial and extrajudicial proceedings, the landlord must obtain leave of the court and, in so doing, must show either:

(a) that it is likely to be materially prejudiced by the continued operation of the stay; or
(b) that it is equitable on other grounds to make such a declaration.

If the landlord is not receiving current performance of the lease terms or if the premises are vacant, the landlord may be able to show material prejudice. However, unlike the Code, there is no positive duty on any person to maintain the obligations under the lease pending the filing and approval of the proposal. The landlord must weigh the benefits of repossessing the premises against receiving the priority payment on rejection.

Under the CCAA, the courts are inclined to allow the debtor to continue in occupation of the demised premises without being required to pay for the use and occupation during the period between the initial application pursuant to the CCAA and the time of surrender of the demised premises to the landlord pursuant to the approved plan. Debtors may recognize this factor, as they usually insert provisions in the initial order allowing for the payment of occupancy costs. However, if the parties


374 BIA s. 69.4.

375 In a liquidation case, because the property of the bankrupt vests in the trustee, the liability to pay occupation rent is a personal liability of the trustee [*Re Auto Experts Ltd.* (1921), 1 C.B.R. 418 (Ont. S.C.)]. See also e.g., *Landlord's Rights on Bankruptcy Act*, R.S.A. 1980, c. L-7; cf. *Commercial Tenancy Act*, supra note 333, s. 32(9)].

376 *E.g.*, in the proceedings involving Silcorp Ltd., the following provision appeared in the order issued by the Ontario Court of Justice (General Division) which was granted on June 11, 1992:

"24. THIS COURT FURTHER ORDERS THAT the relevant Applicant pay occupation rent for any leased or subleased premises which such Applicant occupies for the period commencing with the date of this Order during which such Applicant enjoys actual occupation of such leased or subleased premises, however, with respect to leased or subleased premises for which the lease or sublease has been abandoned by the relevant Applicant, the landlord
are unable to agree on the quantum of the occupancy costs, the court would have to determine the issue. There do not, however, appear to be any reported cases on this point.

As the courts are inclined to provide the debtor with an opportunity to attempt a reorganization, they usually grant a very broad stay of proceedings pursuant to section 11 of the CCAA. The orders generally mirror the wording of section 11 which stays the commencement or continuation of all actions, suits and proceedings, including proceedings under the BIA. However, in the event that there are significant contracts or interests, the debtor may want specifically to address those matters in the order.

Any reform must address the issue of performance of obligations contained in a real property lease during the period between commencement of the proceedings and rejection of the lease. The reforms must provide a means of securing performance to adequately protect the landlord and they should provide the landlord with remedies for breach of performance or failure to provide adequate protection.

(e) The Landlord's Claim or Compensation for Breach

The quantum of and priority accorded to a claim of a landlord following the decision of the trustee or debtor to reject or repudiate an unexpired lease is perhaps the most significant difference shall have the right to take possession of the leased or subleased premises and to enter into new lease arrangements and the stay provided for in this Order with respect to such leased or subleased premises shall cease to have effect."

377 In the Silcorp Ltd. matter, given the significant number of leases and subleases (Silcorp Ltd. operated the Mac's Convenience Store chain and the Baskin Robbins Ice Cream stores), the debtor chose to include the following in the court order:

"23. THIS COURT ORDERS THAT all persons, firms, corporations and other entities having other agreements with either Applicant are hereby restrained from accelerating, terminating, determining or cancelling such agreements . . . and the landlords of premises leased or subleased by the relevant Applicant are hereby specifically restrained from taking any step to terminate any lease or sublease to which such Applicant is a party whether by notice of termination or otherwise, unless the leave of this Court so to do has been first obtained."
between the rights of Canadian landlords and their counterparts in the United States. If the debtor has not assumed the unexpired lease prior to the rejection, paragraph 365(g)(1) of the Code treats the rejection as a breach immediately before the date the filing the petition. This gives the landlord a prepetition allowable claim under section 502, that is an unsecured claim.\textsuperscript{378} However, if the lease has been assumed prior to its rejection, the claim for a postpetition breach under paragraph 365(g)(2) is given an administrative expense priority under section 503 and paragraph 507(a)(1).\textsuperscript{379}

By not allowing the landlord a priority claim, the Code encourages the reorganization of the debtor, as the landlord's claim is merely unsecured.\textsuperscript{380} It also forces the trustee to consider carefully whether to assume or reject the lease, as an imprudent decision to assume followed by a decision to reject will result in a priority claim being accorded to the landlord. Often, a debtor seeking to reorganize is encountering cash flow difficulties. A policy that requires the estate to part with cash needed for operations, when there is no direct benefit flowing to the estate, discourages reorganizations. Should reorganizations be an objective of a bankruptcy system, landlords must have some incentive to support the reorganization efforts of the debtor.

\begin{footnotes}
\item[378] \textit{In re Abernathy}, 10 B.R. 418 (Bankr. M.D. Ala. 1981); cf. \textit{In re Chateaugay Corp.}, supra note 352, where the court held that "...a debtor may incur priority expenses under an executory contract or unexpired lease, without an express election, if the bankrupt estate derives benefits under that contract." [at 955]. With respect, the Code specifically provides for the priority of claims of a landlord and accordingly, if the lease is rejected, the landlord is entitled to no more than an unsecured claim.

\item[379] D. Fogel, "Executory Contracts and Unexpired leases in the Bankruptcy Code" (1979-1980) 64 Minn. L. Rev. 341 at 378. Administrative expenses have been described as "specially favored post-petition claims, given priority in asset distribution over most other claims against the bankruptcy estate." [\textit{In re Mid Region Petroleum, Inc.}, 1 F.3d 1130 at 1132 (10th Cir. 1993)].

\item[380] The court in \textit{Mid Region Petroleum, Inc.}, \textit{ibid}. justified the subordination of certain claims as follows:

"One of the goals of Chapter 11 is to keep administrative costs to a minimum in order to preserve the debtor's scarce resources and thus encourage rehabilitation. In keeping with this goal, s. 503(b)(1)(A) was not intended to 'saddle debtors with special post-petition obligations lightly or give preferential treatment to certain select creditors by creating broad categories of administrative expenses.' The policy behind giving priority to administrative expenses in Chapter 11 proceedings is "to encourage creditors to supply necessary resources post-petition". [at 1134].
\end{footnotes}
Of most concern to debtors who are considering proposal proceedings under the BIA is the priority payment accorded to a landlord following repudiation of its lease. The priority payment represents compensation to the landlord equal to the lesser of 6 months rent under the lease and the rent for the remainder of the lease from the date on which the repudiation takes effect. For the court to approve the proposal, the proposal must provide for the priority payment and the tenant must satisfy the court that it can and will make the payment. Following approval of the proposal, the court may annul it, which results in the bankruptcy of the tenant. This provision should deter any tenant from repudiating a lease with no intention of meeting the priority payment.

The priority payment provision places an undue burden on tenants who are legitimately attempting to reorganize their affairs to continue carrying on business. The BIA's proposal provisions apply only to insolvent persons, which are, by definition, unable to meet their obligations or have ceased paying current obligations as they generally become due or have a negative net worth. Accordingly, such person does not have sufficient cash flow to make the priority payment or does not have unencumbered assets to raise sufficient funds to make the payment. Without outside funding, therefore, the repudiation remedy will usually be illusory.

Because of the requirement for the priority payment, the CCAA is the "remedy of choice" for debtors seeking to disclaim lease obligations, as the court has a discretion not to award damages or compensation for breach.

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381 BIA s. 65.2(3).
382 BIA s. 60(1.5).
383 BIA s. 63.
384 BIA s. 2 "insolvent person".
385 Newbould, supra note 163 at 51.
(f) Standards for Rejection or Repudiation

The Code does not provide the trustee with any guidance concerning the standards governing the decision to assume or reject an unexpired lease. Accordingly, trustees must resort to pre-Code case law to determine possible standards.386 Under the "onerous and burdensome test,"387 the trustee's right to reject an unexpired lease arises only if there would be an actual net economic loss to the estate unless the trustee rejects the contract or if it can show that "the contract creates a drain on the debtor's assets by requiring the outlay of funds for an obsolete purpose."388 The objective nature of this standard has been described as an "inappropriate limit" on the discretion of the trustee to fashion an optimal reorganization strategy.389 The courts have agreed with this analysis and have not applied this standard to any great extent.

The test that appears to have found favour is the "business judgment test,"390 which provides a more flexible standard. It allows the court to evaluate the decision of the trustee to assume or reject in light of the circumstances of the case.391 The business judgment test requires the trustee to balance the competing interests involved in the reorganization case. The trustee must weigh the interests of the debtor, the landlord and the general creditors of the estate to determine the most prudent course of action and, of course, the trustee cannot ignore the fact that the debtor is seeking to continue carrying on the business, which is the overriding consideration in a reorganization case. If the trustee has

386 Ehrlich, supra note 321 at 20.
388 Bkr-L Ed, Code Commentary and Analysis s. 15:97.
389 Norton Bankruptcy Law & Practice s. 23.08. See also In re Chi-Feng Huang, 23 B.R. 798 at 800 (9th Cir. 1982).
391 In re Minges, 602 F.2d 38 (2d Cir. 1979), where the court held that it was unnecessary to show that the rejection would aid in the debtor's rehabilitation.
exercised its discretion reasonably, the court will not upset its business judgment.\textsuperscript{392} This, it has been said,

\ldots would further the goals of the Code placing responsibility for administering the estate with the trustee, not the court, it would expedite the administration of estates and encourage rehabilitation by permitting the replacement of marginal business arrangements with profitable business arrangements.\textsuperscript{393}

Under the BIA, within 15 days after being given notice of the repudiation of the lease, the landlord may apply to the court for a declaration that the repudiation is inapplicable to its lease.\textsuperscript{394} The debtor must then show that it cannot make a viable proposal without repudiation of that and all other repudiated leases.\textsuperscript{395} The debtor need not show that it can make a viable proposal; only that the proposal would not be viable without the repudiation.\textsuperscript{396} This standard, like the standards imposed by the American courts, focuses on the effect of the lease on the debtor which, in turn, determines the viability of the proposal. However, the Canadian test allows the courts to look beyond the "business judgment" of the debtor and examine the viability of the proposal itself. If the proposal cannot succeed, given the position of the creditors, one wonders whether the court will allow the repudiation.

In a CCAA proceeding, the parties or the courts usually deal with disputes concerning the fairness of treatment or proposed treatment of landlords prior to the court application to approve the plan of arrangement, through interlocutory proceedings or negotiation.


\textsuperscript{393} Bkr-L Ed, Code Commentary and Analysis s. 15:97 Use of the business judgment test has recently been confirmed in \textit{In re Orion Pictures Corporation}, 4 F.3d 1095 at 1099 (2d Cir. 1993), where the court said:

"In reviewing the trustee's or debtor-in-possession's decision to assume an executory contract, then, a bankruptcy court sits as an overseer of the wisdom with which the bankruptcy estate's property is being managed by the trustee or debtor-in-possession, and not, as it does in other circumstances, as the arbiter of disputes between creditors and the estate."

\textsuperscript{394} BIA s. 65.2(2).

\textsuperscript{395} \textit{Ibid}.

\textsuperscript{396} \textit{Janpar, supra} note 264 at 10.
4. Considerations for Reform

The BIA is directed to a particular type of debtor, viz., one that can secure additional capital to make certain priority payments, including payment of amounts to Her Majesty in respect of employee source deductions, to employees and to landlords. In other words, the BIA requires the debtor to use capital for unproductive antecedent debts. In the absence of that requirement, the debtor could use the funds for prospective working capital. If a debtor can raise significant monies, those monies would be better directed to ensure the ongoing viability of the operation. Legislation that favours one group of antecedent creditors over others can hardly be considered equitable and does not encourage the debtor’s rehabilitation. The macroeconomic consequences of effectively disallowing reorganization proceedings may be more detrimental to the priority payees than providing them with a preferential payment. For example, an employee would prefer to receive a pro rata unsecured claim in a reorganization proceeding and retain employment in a reorganized entity with sufficient working capital to receiving a priority payment of two thousand dollars from an employer with a shortage of working capital, as the employer may ultimately face a liquidation proceeding.

Any reform should eliminate all preferred claims that do not add current or prospective value to the debtor. In particular, the policymakers should eliminate the preferred claim of the landlord in a liquidation proceeding, as suggested by the Colter Committee Report. With the current priority enjoyed by landlords, they have no incentive to support the reorganization efforts of their tenants. It may be very elementary to observe that the landlord, in a liquidation proceeding, may receive up to 6 months rent, which is the quantum of the priority payment due following a repudiation of the lease.

397 Of course, priority must be accorded the claims of creditors which are providing current services to the debtor, such as the trustee’s fees and disbursements, creditors which render supplies and services following the commencement of the proceedings and occupation rent.

398 BIA ss. 60(1.3) and 136(1)(d).

399 See supra note 273 and accompanying text.

400 BIA s. 136(1)(f).
This is an inappropriate way to encourage the cooperation of landlords in the reorganization efforts of their tenants. After all, in most instances, the landlord will welcome the rejection of a lease by an insolvent tenant to secure full occupancy of the freehold with solvent tenants.\textsuperscript{401} As currently drafted, the BIA provides a landlord with an opportunity to profit from the rejection of a lease, as the landlord will receive the 6-month priority payment and it may be able to relet the premises within the 6-month period for a rental rate exceeding that which the insolvent tenant was paying.

Critics note that to deprive the landlord of a preferred status permits the insolvent debtor to breach contracts that the parties negotiated and entered in good faith. This point is well taken but the nature of a reorganization system is that it compromises all creditors and equity holders, to a certain extent, in the interests of all concerned parties. This objective was concisely stated by Farley J. in \textit{Lehndorff}:

\begin{quote}
It appears to me that the purpose of the CCAA is also to protect the interests of creditors and to enable an orderly distribution of the debtor company's affairs. This may involve a winding-up or liquidation of a company or simply \textit{a substantial downsizing of its business operations}, provided the same is proposed in the best interests of the creditors generally.\textsuperscript{402} [emphasis added].
\end{quote}

The Canadian policymakers should review the common law standards established under the CCAA. They could translate the more desirable standards into legislation providing the courts a margin of flexibility. For example, it may be reasonable to provide some recompense to landlords for the loss of their bargains. To fix this amount at the equivalent of 6 months rent in all circumstances is unnecessarily generous. Requiring a prompt decision by the trustee or debtor to enable the landlord to mitigate its losses and provision for current payment of occupation rent would treat both sides equitably. Of course, the landlord must be assured payment of occupation rent. Failure to provide occupation rent to the landlord should result in personal liability on the part of the entity in possession of the demised premises. Alternatively, that entity could provide the landlord with adequate security.


\textsuperscript{402} \textit{Supra} note 149 at 32.
This recognizes the "value-added" aspect of the lease during the reorganization proceeding. This will also provide the landlord with the necessary adequate protection during the period between the commencement of the proceedings and the abandonment of the premises by the debtor.

In the United States, the time within which the trustee must make its decision to assume or reject an unexpired lease has caused much litigation.\textsuperscript{403} To impose a time limit of 60 days fetters of the discretion of the court. The 60-day period should be the maximum, but the court should have a discretion to abridge the time in appropriate circumstances.

Finally, the terminology should accurately reflect the result sought.\textsuperscript{404} The concept of disclaimer more accurately reflects the objectives of the legislation. Using this term would prevent the courts from using concepts that carry certain "conceptual baggage" that the policymakers did not intend. Also, parties will not assume obligations or liabilities that were not in the contemplation of the policymakers.

C. \textbf{FINANCING THE PROCEEDING}

When a debtor is forced to seek the protection of a reorganization regime, the underlying difficulty is usually a lack of unencumbered cash required to carry on the business in the ordinary course. This results in the debtor attempting to pay the most aggressive creditors, attempting to protect the principals of the debtor through the payment of claims that would otherwise impose personal liability on them, ignoring the problem entirely in the hopes that its fortunes will see a turnaround, or seeking the sanctity of available reorganization procedures. Should the debtor seek to invoke the provisions of a reorganization regime, the first task is to find available cash with which to operate the business during the period between the commencement of the proceeding and confirmation of the plan of arrangement.

Without statutory provisions governing accessibility to cash during the proceeding, the

\textsuperscript{403} See generally, Sabino and Susca, \textit{supra} note 342.

\textsuperscript{404} See chapter V(B)(2), above.
operating capital may come from three sources. First, the debtor may have cash from operations that it earmarked for the possibility of an insolvency proceeding. This source of cash is usually unavailable, as the debtor will have expended all available cash in its attempt to maintain the operation or the cash will be subject to security, such as an assignment of rents or receivables. The second source is cash produced through operations or through liquidation of assets or parts of the business. Again, in all likelihood, the proceeds will be pledged to a creditor or encumbered by some type of security interest, such as an assignment of proceeds or general security covering all or substantially all of the debtor's assets. The final source is the extension of trade credit or debt or equity financing. The likelihood of an insolvent debtor obtaining credit, without statutory provisions according special protections, is highly unlikely.

As the cash or assets that the debtor could use to generate cash are usually subject to a security agreement, any statutory regime that allows the debtor access to these resources may adversely affect the creditor holding the security. The following statement reflects this tension between the interests of secured creditors and debtors:

On the one hand, the Court should be anxious to assure a secured creditor that its security interest in cash collateral is not lost because it is used up or dissipated by the Debtor. On the other hand, the Court must also assure that the Debtor's cash which is the life's blood of the business, is available for use even if to a limited extent.405

Thus, the courts must attempt to balance the interests of the debtor against those of the secured creditor "to determine the funding arrangement which will keep the debtor operating while maintaining adequate protection for the creditor."406

This section will examine the provisions of the Code that attempt to strike the delicate balance between the interests of the debtor in having an opportunity to put forth a plan of reorganization with a view to rehabilitation and those of the creditors who would otherwise have priority over the cash resources of the debtor. In particular, we will examine the use of either cash reserves or cash


generated through operations or liquidation, that are subject to a security interest and the obtaining of new credit.

As neither the BIA nor the CCAA contains provisions governing the financing of the debtor's operations during the period between commencement of the proceeding and presentation of a plan, other than through borrowings of an interim receiver, this section will examine how the Canadian courts approach these matters. In particular, this section will examine the issue of whether the absence of specific provisions governing these matters promotes the objectives of the legislation.

1. Use of Cash Collateral

The policymakers intended the Code to reflect the changes caused by the adoption of the Uniform Commercial Code by all states in the United States, except Louisiana, which adopted it only partially. In other words, the increased use of secured credit required accommodating provisions in bankruptcy legislation. The Tassé Report recognized a similar increase in use of secured credit and made similar recommendations. Theoretically, insolvency legislation should protect a secured creditor's interest in the collateral, provided the secured creditor has taken all necessary steps to protect that interest. The extent of the protection depends on the nature of the collateral.

The Code gives special protection to a creditor that holds a security interest in "cash collateral." The reason for this special protection is that cash collateral is liquid, fungible and easily dissipated, consumed or concealed. In providing special protection to secured creditors with an interest in cash collateral, the Code attempts to reconcile the interests of secured creditors and debtors.

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407 This type of cash is referred to in Code as "cash collateral". See discussion, chapter V(C)(1), below.


409 Tassé Report at 56-57, 96-98.

410 House Report at 182; In re Mickler, supra note 405 at 123, where the court described cash collateral as "highly volatile" and "subject to rapid dissipation."
Secured creditors are interested in protecting collateral in which they have a negotiated interest and in maintaining their priority positions over that collateral. The debtor usually requires the cash collateral to meet day to day expenses to survive long enough to prepare a plan of reorganization.411

Paragraph 363(c)(1) of the Code grants the trustee the right to use, sell or lease property of the estate, whether or not subject to a security interest, in the ordinary course of business, without court approval.412 Paragraph 363(c)(2) excepts cash collateral from the general grant. The trustee may not be use, sell or lease cash collateral without the consent of all parties with an interest in it or the authority of the court, after notice and hearing.413

Subsection 363(a) of the Code defines "cash collateral" as:

... cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.414

411 This issue arises as a result of the provisions of the Code that permit the trustee or debtor in possession to operate the business of the debtor pursuant to section 1108 of the Code. See discussion chapter IV(A)(1), above.


413 In re Rankin, 49 B.R. 565 at 570 (Bankr. W.D. Mo. 1985).

414 The House Report recommended a broader definition using the term "soft collateral" instead of the definition recommended by the Senate Report, which was ultimately adopted. The definition of "soft collateral" included inventory, accounts, contract rights, general intangibles and chattel paper. The Senate Report made it clear that the collateral need not be cash collateral on the date that the proceeding is commenced, but would extend to proceeds of "non-cash" collateral which is disposed of, provided that the proceeds remain subject to the lien on the original collateral under section 552(b) of the Code [Senate Report at 55]. Subsection 552(b) of the Code provides:

"Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, rents, or profits of such property, then such security interest extends to such proceeds, product, offspring, rents, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and hearing and based on the equities of the case, orders otherwise."
The 1898 U.S. Act contained no special provisions governing the debtor's use of cash collateral, and left development of the law concerning the debtor's use of cash collateral to the courts. The courts took two divergent approaches to this problem. In *Reconstruction Finance Corp. v. Kaplan*, the court sanctioned the use by the debtor of cash collateral on the basis that the 1898 U.S. Act made no distinction between cash collateral and other types of collateral. As such, the court ordered the creditor to turn over the cash collateral for use in the debtor's reorganization. The Second Circuit Court of Appeals took a different approach in *Third Ave. Transit Corp. v. Lehman*, where the court imposed very strict guidelines governing the debtor's use of cash collateral. The debtor had to show that access to the funds was imperative, there were no other sources from which it could obtain the funds and there was a strong likelihood that it could accomplish a reorganization within a reasonable time, without injuring the interest of the secured creditor.

In enacting the Code, Congress chose not to adopt either of these approaches. It recognized the unique nature of cash collateral and attempted to protect the secured creditor's interests through substantive and procedural means.

The Code provides various safeguards that are structured to protect the secured creditor's rights in cash collateral. Paragraph 363(c)(2) requires the debtor to obtain the consent of each entity that has an interest in the cash collateral or secure a court order allowing it to use the cash collateral. The debtor usually seeks the consent through agreement with the creditor. The agreement will outline the parameters for the debtor's use of the cash collateral and will usually be incorporated into an

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416 185 F.2d 791 at 798 (1st Cir. 1950).

417 198 F.2d 703 at 705-706 (2d Cir. 1952).

order.\textsuperscript{419} To be enforceable under paragraph 363(c)(2), the parties must have entered into the agreement postpetition\textsuperscript{420} and although it does not have to be in writing, it must be expressed.\textsuperscript{421} Should the creditor merely unconditionally consent to the debtor's use of the cash collateral, there is no need to have the court approve the agreement. However, the creditor may attempt to seek concessions or rights that are unrelated or only marginally related to use by the debtor of the cash collateral, as consideration for allowing the debtor to use it.\textsuperscript{422} For example, the creditor may attempt to obtain a release of potential or existing lender liability claims, have prepetition liens validated or have the debtor acknowledge the quantum of a debt.\textsuperscript{423} The creditor may also seek to control the progress and outcome of the proceeding. In such a case, the creditor will likely require the debtor to obtain court approval of the agreement.\textsuperscript{424}

If the debtor feels that the concessions the creditor is seeking are unsatisfactory, it may wish to have the court rule on the issue, despite the risk that the court may not approve the debtor's use of the cash collateral over the objections of the secured creditor. The debtor would seek court approval under subparagraph 363(c)(2)(B) of the Code. Although the debtor may have valid reasons for attempting to obtain court approval, the creditor may also feel that taking the matter to court will produce beneficial results. Should the secured creditor feel that the debtor is unable to show adequate

\textsuperscript{419} Ibid.

\textsuperscript{420} In re Pine Lake Village Apartment Co., 16 B.R. 750 at 756 (Bankr. S.D.N.Y. 1982).

\textsuperscript{421} In re Cross Baking Co., 818 F.2d 1027 (1st Cir. 1987) where the court held that the secured creditor did not discharge the burden of showing that it had taken the requisite steps to protect its security interest.

\textsuperscript{422} Norton Bankruptcy Law & Practice s. 87:8.

\textsuperscript{423} Ibid.

\textsuperscript{424} Court approval would be obtained pursuant to U.S. Bankruptcy Rule 4001. A discussion of the binding effect of the court approval thus obtained appears in S.A. Stripp, "Balancing the Interests in Orders Authorizing the Use of Cash Collateral in Chapter 11" (1991) 21 Seton Hall L. Rev. 562.
protection of its interest, it may refuse to consent. The debtor's only alternative is to seek court approval. The court has discretion to prohibit or condition the debtor's use of the cash collateral in such manner and to the extent necessary to provide the secured creditor with adequate protection of its interest.

The Code does not prescribe a standard for the courts to use in determining the rights of the parties in cash collateral litigation. The hearing and notice requirements of section 363(c)(3) however, are lenient and tend to favour the debtor's interests. Most courts attempt to balance the rights of the secured creditor and the debtor. However, others have focused on the needs of the debtor or the adequacy of the protection accorded to the secured creditor.

The concept of adequate protection, when the debtor proposes to use cash collateral, arises because of subsection 363(e), which provides:

> Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease

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425 See Code ss. 363(e) and 363(o).

426 House Report at 345. See also Re George Ruggiere Chrysler-Plymouth, Inc., 727 F.2d 1017 (11th Cir. 1984) where the court allowed the debtor to use the cash collateral that exceeded the wholesale price of the inventory supplied by the creditor, notwithstanding that the debt exceeded the value of the collateral by about $1 million. Adequate protection, the court held, was limited to the lesser of the amount of the secured claim and the amount of the collateral. In this case, the latter figure governed.

427 Mount, supra note 415 at 349.

428 See e.g., In re Cerrico Realty Corp., 127 B.R. 319 at 324-325 (Bankr. E.D.N.Y. 1991); In re Quality Interiors, Inc., 127 B.R. 391 at 395 (Bankr. N.D. Oh. 1991); See quote from In re Mickler, supra note 405 and accompanying text.


430 In re Prime, Inc., supra note 406 at 219.

431 The general concept of adequate protection is discussed in chapter V(A)(1)(b), above.
as is necessary to provide adequate protection of such interest.\footnote{432}

Paragraph 363(o)(1) casts the burden of proof on the debtor with respect to the issue of adequate protection. The debtor must propose the method of protection that, in its view, will adequately protect the secured creditor.\footnote{433} The court will then determine the adequacy of the protection. Section 363 provides that, once the creditor requests protection, the court \textit{shall} condition the use of the cash collateral by requiring the debtor to provide the secured creditor with adequate protection or prohibit the debtor from using it. Section 361, which sets forth the alternative means of providing adequate protection, refers specifically to section 363.

In providing adequate protection, the courts follow the Congressional intent that entitles the secured creditor to essentially what it bargained for\footnote{434} and, in attempting to make that determination, the courts often focus on the diminution of the value of the creditor's interest in the collateral. Cash collateral is unique, in that valuation of the collateral poses no difficulty. That is, diminution in value is equal to the amount of the cash used. Accordingly, to adequately protect the creditor, the court may require debtor to provide a replacement lien or periodic payments, as it is the value of the secured

\footnote{432} The hearing referred to in subsection 363(e) of the Code is considered to be a "final hearing" in accordance with the terms paragraph 363(c)(3) of the Code. Paragraph 363(c)(3) of the Code provides that the initial hearing to determine whether the trustee may use, sell or lease the cash collateral is a "preliminary hearing" and that the trustee will succeed "only if there is a reasonable likelihood that the trustee will prevail at the final hearing under subsection (e) of this section." Stripp, \textit{supra} note 424 explains the distinction between an order resulting from a preliminary hearing and one emanating from a final hearing. A preliminary or interlocutory order, may be revised at any time prior to the entry of a final order. A final order, on the other hand, is only subject to review on appeal. The author concludes that notwithstanding the designation of an order or hearing as final, most cash collateral orders are interlocutory. [at 585-589]. This characterization may have significant effects on the parties, not the least of which are the legal and other costs of undertaking an appeal. In addition, there is no assurance that an appeal will be entertained by the courts as leave may be required, depending on how the court characterizes the order [28 U.S.C. s. 158(a)].

\footnote{433} See \textit{e.g.}, \textit{In re O.P. Held, Inc.}, 74 B.R. 777 (Bankr. N.D.N.Y. 1987). The arguments and the considerations are the same as those discussed in chapter V(A)(1)(b) and accordingly, the reader is referred to that chapter.

\footnote{434} House Report at 339.
creditor's interest that requires protection, not the collateral itself. Alternatively, the value of the creditor's non-cash collateral may be sufficient to offset the diminution in the value of the cash collateral.

Paragraph 363(c)(4) provides that, without a court order authorizing the use of the cash collateral or the consent of each entity with an interest in the cash collateral, the debtor must segregate and account for any cash collateral in its possession, custody or control. In all likelihood, the cash collateral order or any agreement among the parties, will require an accounting of the funds.

We should not downplay the importance of the segregation and accounting of funds. Although it is not necessary to protect the value of the creditor's interest in the collateral, it may be necessary to protect the secured creditor's security interest in "proceeds." The Code entitles the secured creditor to maintain its interest in proceeds to the extent provided by the security agreement entered into by the debtor and the secured creditor and "by applicable nonbankruptcy law." The Uniform Commercial Code is the most important nonbankruptcy law that is applicable. Subsection 9-306(2) of the Uniform Commercial Code provides:

Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor. [emphasis added]

Segregating and accounting for the funds may meet the requirements of the Uniform Commercial

435 Stripp, supra note 424 at 567-568.

436 Norton Bankruptcy Law & Practice s. 87:7.

437 One author suggested that an accounting may be an integral part of adequate protection and that orders for adequate protection may contain "severe restrictions" on the debtor's use of the collateral. Unless one can characterize the duty to account and the restrictions imposed on the trustee as the "realization" by the secured creditor of the "indubitable equivalent of such entity's interest in such property," the duty to account and restrictions are in fact not components of adequate protection, but those elements are granted pursuant to the court's power under section 105(a) of the Code. Although the right of the court to make such orders is not questioned, one must draw a distinction between the elements contained in the order to make it clear that adequate protection speaks value only to and not to collateral rights.

438 Code s. 552(b).
The Code does not provide sanctions for the use of cash collateral in violation of the Code, a cash collateral order or a consent agreement among the parties. However, the courts impose such sanctions pursuant to subsection 105(a) of the Code. The sanctions are drawn from other remedies in the Code, such as the appointment of a trustee, conversion or dismissal of the case, lifting the automatic stay or granting of retroactive adequate protection, such as through the granting of a replacement lien. The courts have also drawn from other areas of the law, such as liability for the tort of conversion and contempt. Many of the sanctions are directed towards the debtor's misdeed, and although punitive in nature, they fail to take account of the underlying objective of a business reorganization system and the possibility of injury to parties other than the wrongdoer. In other words, notwithstanding the debtor's misuse of the cash collateral, the business may be worth saving for the benefit of all. It may be more appropriate to impose personal sanctions against those who

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439 It is beyond the scope of this paper to discuss the complexities involved in section 9-306 of the Uniform Commercial Code. One author has called this provision "awesomely complex" [T.M. Quinn, ed., Uniform Commercial Code Commentary and Law Digest (Boston: Warren, Gorman & Lamont, 1978) at 9-168].

440 Mount, supra note 415 at 361.

441 In re Aerosmith Denton Corp., 36 B.R. 116 at 119 (Bankr. N.D. Tex 1983), where the court exercised the broad discretion given it by the Code s. 105 to grant the creditor a replacement lien to secure the cash collateral wrongfully used by the debtor.

442 Anchorage Boat Sales, Inc., supra note 56. See also discussion in chapter IV(A)(4), above.


444 Anchorage Boat Sales, Inc., supra note 56; see also discussion in chapter V(A)(1)(b), above.

445 In re Aerosmith Denton Corp., supra note 441; In re Casbeer, 793 F.2d 1436 at 1443-1444 (5th Cir. 1986).


447 In re Krisle, 54 B.R. 330 (Bankr. D.S.D. 1985). In this case the debtor was incarcerated until such time as he purged his contempt by complying with a court order requiring him to turn over cash collateral wrongfully taken from the DIP account. His attorney was also incarcerated for participating in the scheme by advising the debtor, without proper grounds, to disobey the court order.
precipitated the misuse, such as the directors or officers of the debtor or the trustee, while not destroying the possibility of reorganization. The imposition of personal liability could serve to recompense the creditor for any loss that it suffers.

Neither the BIA nor the CCAA contains provisions prohibiting the debtor's use of cash collateral during the reorganization proceeding. Once the insolvent person commences a proposal proceeding, the BIA specifically allows it to use the cash collateral. As the BIA contains no provision for the court to provide adequate protection to the secured creditor, the insolvent person could dissipate the cash collateral and the secured creditor would have no recourse other than to seek a declaration that the stay of proceedings no longer operates in respect of that creditor. This may be small comfort to the secured creditor if it is unaware of the commencement of the reorganization proceedings for a period during which the insolvent person is realizing on the creditor's cash collateral.

The courts take a similar approach under the CCAA. That is, the rights of secured creditors

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448 BIA s. 69.1(1)(b) provides:

"Subject to subsections (2) to (6) and sections 69.4 and 69.5, on the filing of a proposal under subsection 62(1) in respect of an insolvent person,

... no provision of a security agreement between the insolvent person and a secured creditor that provides, in substance, that on

(i) the insolvent person's insolvency,
(ii) the default by the insolvent person of an obligation under the security agreement, or
(iii) the filing of a notice of intention under section 50.4 or of a proposal under subsection 62(1) in respect of the insolvent person,
the insolvent person ceases to have such rights to use or deal with assets secured under the agreement as he would otherwise have, has any force or effect until the proposal has been fully performed or the insolvent person becomes bankrupt;"

Subsection 69(b) which deals with the filing of a notice of intention to make a proposal is, in substance, the same as the foregoing.

449 BIA s. 69.4.

450 Under subsection 50.4(6), the proposal trustee has 5 days within which to notify creditors of the filing of the notice of intention to make a proposal.
are subordinated to the objectives of the CCAA. In *Chef Ready*, the British Columbia Court of Appeal stated:

... if the bank signifies and collects the accounts receivable, [the debtor] will be deprived of working capital. Collapse and liquidation must necessarily follow ... Given the economic circumstances which prevailed when the C.C.A.A. was enacted, it is difficult to imagine that the legislators of the day intended that result to follow.\(^{452}\)

This position is untenable. This decision compromises the rights of the secured creditor to those of the debtor. Moreover, the enhanced value through reorganization will accrue, not to the secured creditor, but to the trade creditors and equity holders. This situation reinforces the need for some type of protection being accorded to secured creditors during the conduct of the reorganization proceedings.

To use cash collateral, the debtor must provide adequate protection to the secured creditor. Furthermore, the debtor must be able to satisfy the court that the reorganization proceeding has some prospect of success, on an objective basis.\(^{453}\) Although this may be a difficult matter to establish at the outset of the case, the standard will not be so stringent at that stage and will require the court to make an objective determination based on the evidence presented. Later in the case, the debtor faces a more onerous burden. The debtor must present evidence of a pressing need for use of the cash collateral. The sanctions for misuse of the cash collateral should be harsh and strictly enforced, reflect the degree of culpability attendant on the misuse and impose personal liability on the individuals involved.

2. **Obtaining Credit**

The Code and the BIA contain provisions allowing the debtor to obtain credit and grant security to finance the reorganization proceedings. The Code allows direct financing through the

\(^{451}\) *Chef Ready*, supra note 95.


\(^{453}\) See discussion chapter III(C)(3), above.
trustee or the debtor in possession. The BIA permits neither the insolvent person nor the proposal trustee to obtain financing but may permit an interim receiver to borrow and grant security during the reorganization proceeding.

In most instances, the debtor will not have unencumbered assets available with which to obtain financing to maintain the operations and put forth a plan of reorganization. Without special protection, lenders will be unwilling to advance funds to such a debtor. After all, if an existing secured creditor has security on all or substantially all of the property of the debtor, it is unthinkable that a lender would advance new funds on the assurance that the new lender would have a security interest subordinate to existing security interests. Because of the special treatment accorded to lenders extending new financing under the Code and because the debtor is, in some cases, relieved from the obligation of maintaining prepetition debts in good standing, postpetition financing may be less speculative than financing an entity that has not sought the protection of the Code.

The previous section in this chapter dealt with the debtor's use of cash collateral as a means of financing the proceeding. Section 364 is the exclusive chapter of the Code dealing with the obtaining of new credit by the estate. That section, like all of the administrative powers, attempts to balance the interests of the debtor in reorganizing its affairs with the equitable treatment of creditors. It attempts to adequately protect the interests of existing creditors.

Subsections 364(a) to (d) provide:

(a) If the trustee is authorized to operate the business of the debtor . . . , unless the court orders otherwise, the trustee may obtain unsecured credit and incur unsecured debt in the

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454 Code s. 364.

455 BIA ss. 31 and 47.2.

456 Norton Bankruptcy Law & Practice s. 38:1.

457 Senate Report at 57 states that section 364 of the Code "governs all obtaining of credit and incurring of debt by the estate." [emphasis added]

ordinary course of business allowable under 503(b)(1) of this title as an administrative expense.

(b) The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.

(c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt -

1. with priority over any or all administrative expenses of the kind specified in sections 503(b) or 507(b) of this title;
2. secured by a lien on property of the estate that is not otherwise subject to a lien; or
3. secured by a junior lien on property of the estate that is subject to a lien.

(d) (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if -

A. the trustee is unable to obtain such credit otherwise; and
B. there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

2. In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

The structure of those subsections requires the trustee to seek financing at various levels, each succeeding level requiring the trustee to overcome more stringent procedural and evidentiary obstacles but providing potential postpetition lenders with an increasing level of security. At the "lowest" level is unsecured credit obtained "in the ordinary course of business." The trustee may obtain this

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459 Norton Bankruptcy Law & Practice s. 87:15.

460 Code s. 364(a). Some courts have defined the term "ordinary course of business" using its plain meaning. See e.g., In re Lockwood Enterprises, 52 B.R. 871 at 874 (Bankr. S.D.N.Y. 1985), where the court determined that the credit would fall within the meaning of the term if the credit is of the type which is normally or customarily sought by the debtor in its business. In analyzing this issue, the courts will look to the history of the business and the general practices in the industry. Examples of matters that do not fall within its ambit are the purchase of capital assets or an unusually large volume of supplies or the provision of extensive services are expenses incurred outside of the ordinary course of business [ In re Photo Promotion Associates, Inc., 87 B.R. 835 (Bankr. S.D.N.Y. 1988)], service charges, interest and late penalties [In re Kenney's Franchise Corp., 21 B.R. 461 at 462 (Bankr. W.D. Va. 1982)], and amounts advanced that will not assist in the reorganization and rehabilitation of the debtor or for which the creditor has some ulterior motive [Re C.E.N., Inc., 86 B.R. 303 at 305-306 (Bankr. D. Me. 1988)].
type of credit without court approval. To receive an administrative expense priority, subparagraph 503(b)(1)(A) requires that the expenses are "actual, necessary costs and expenses of preserving the estate." In other words, the postpetition lending must be beneficial to the debtor's objectives and creditors generally, be actual and necessary and provide a substantial contribution to the estate and the unsecured creditors. In addition, subsection 364(a) requires the obtaining of the credit or incurring of debt to be "in the ordinary course of business." This is an important qualification, as credit extended outside the ordinary course of business requires court approval. Failure to obtain

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461 Norton Bankruptcy Law & Practice s. 38:2.

462 Code s. 503(b)(1). An administrative expense, although considered to be a priority claim, only gives the postpetition claimant priority over other unsecured claims. However, it is still an unsecured claim that is subordinate to secured claims. This makes postpetition lending using this method relatively undesirable, as assets in a reorganization proceeding are generally fully encumbered in favour of secured creditors. Since the value of the assets usually falls below the secured claims, administrative expenses are often not paid in full [M.M. Jaffe, "Chapter 11 Strategies and Techniques - Creditors' Committees, Effective Use of Plan Provisions, Objections to Confirmation, Financing a Chapter 11 Case, 'Cramdown' and How it Works" (1985) 59 Tulane L. Rev. 1298 at 1324]. Because of this limited protection, credit granted under subsection 364(a) will be limited to creditors with the least amount of power vis-a-vis the estate. Typically, these would include trade creditors [M.R. Rochelle, "Post-Filing Loans to the Chapter 11 Debtor: Good Money After Bad" (1990) 107 Banking L.J. 344 at 345]. Even trade creditors may be unwilling to extend credit to the trustee until creditworthiness is proven [Ibid]. However, given the often fierce competition in the marketplace, trade creditors may be more than willing to supply goods and services to reputable trustees on normal credit terms. Should the trade creditor demand cash on delivery, the trustee will more than likely locate other suppliers who will provide goods and services on terms. Accordingly, use of subsection 364(a) is likely very prevalent.


464 In re Patch Graphics, Inc., 58 B.R. 743 at 745 (Bankr. W.D. Wisc. 1986); In In re SMB Holdings, 77 B.R. 29 at 32 (Bankr. W.D. Pa. 1987), the court reflected its views on this requirement as follows:

"The goods and services provided must have been given to or actually benefit the debtor-in-possession, and must not be intended to further the self-interest of the particular claimant. Therefore, only when potential creditors are induced to provide goods and/or services to the debtor-in-possession are the purposes of the administrative priority fulfilled." [citations omitted].

465 In re Patch Graphics, Inc., ibid.

466 Code s. 364(b).
court approval may result in the denial of the claim as an administrative expense, in which case, the
creditor will rank as an ordinary unsecured creditor, subordinate to secured creditors and administrative
expense claimants.\textsuperscript{467} Although the creditor may be able to obtain leave \textit{nunc pro tunc}, this relief is
discretionary and the court may deny the application.\textsuperscript{468}

Subsection 364(b) is the next level of obtaining credit. That subsection allows the trustee to
incur unsecured debt outside the ordinary course of business, with leave of the court, and accords a
claim for such a debt the priority of an administrative expense. The claim of the creditor, should it
decide to advance or grant credit without court approval, will be an ordinary unsecured claim,
subordinate to administrative expenses. Again, the creditor may seek leave \textit{nunc pro tunc} and incur
the risk that the court will not grant this relief.\textsuperscript{469} The debtor need not use the funds acquired

\textsuperscript{467} \textit{In re Photo Promotion Associates, Inc., supra} note 460. The rationale for denying a lender an
administrative expense priority on its failure to secure \textit{a priori} approval from the court is that:

"To give priority to a claimant not clearly entitled thereto is not only inconsistent with the
policy of equality of distribution; it dilutes the value of the priority for those creditors
Congress intended to prefer." [\textit{In re Mammoth Mart, Inc.}, 536 F.2d 950 at 954 (1st Cir.
1976)].

cf. \textit{In re Groendyke Co.}, 131 F.2d 573 (7th Cir. 1942) where the court held that the moneys were
advanced by the principal of the debtor in the ordinary course and accordingly, were given an
administrative expense priority.

\textsuperscript{468} \textit{In re Cascade Oil Co.}, 51 B.R. 877 at 882 (Bankr. D. Kan. 1985), where the court said that
such approval would only be given in "unusual circumstances"; for the requirements to obtain leave
\textit{nunc pro tunc}, see \textit{In re American Cooler Co.}, 125 F.2d 496 at 409 (2d Cir. 1942) where the court set
forth the following "guide-posts" for the court to consider in deciding whether to grant leave \textit{nunc pro tunc}:

1. leave would have been authorized if a timely application had been made;
2. the creditors have not been harmed by a continuation of the business made possible by
   the loan; and
3. whether the debtor and lender honestly believed that they had the authority to enter
   into the transaction.

the court held the foregoing to be threshold standards and, in addition, the "equities must strongly
favour the creditor and there must be an absence of prejudice to any interested parties." [at 851-852].

\textsuperscript{469} \textit{Ibid.} and accompanying text.
exclusively for operation of the business, *per se*, but it may use the funds to enhance or preserve the estate, such as through the prosecution or defence of a lawsuit.\textsuperscript{470}

If the trustee is unable to obtain unsecured credit under either subsection 364(a) or 364(b), the court may allow the trustee to obtain credit or incur a debt under subsection 364(c). That subsection grants the creditor, a "superpriority" administrative claim, that will rank ahead of all other administrative expense claims, a lien on unencumbered property of the estate or a subordinate lien on previously-encumbered property of the estate.\textsuperscript{471} Although subsection 364(c) frames the incentives for granting the priority as alternatives, a creditor may seek security for its claim and a superpriority administrative expense claim for any deficiency.\textsuperscript{472} To obtain credit under subsection 364(c), the trustee must show that it was "unable to obtain unsecured credit" under subsections 364(a) or 364(b). Although the trustee need not show that it canvassed every possible source of unsecured credit,\textsuperscript{473} the courts usually take a pragmatic approach and require the trustee to show that it made a *bona fide* effort to obtain financing under subsections 364(a) or 364(b).\textsuperscript{474} The trustee must also show that the credit is necessary for the preservation of the estate\textsuperscript{475} and that the proposed transaction is fair, reasonable and adequate in the circumstances.\textsuperscript{476}

\textsuperscript{470} See *e.g.*, *In re Hartley*, 39 B.R. 273 (Bankr. N.D. Oh. 1984).

\textsuperscript{471} Code s. 364(c)(1), (2) and (3), respectively.

\textsuperscript{472} Jaffe, *supra* note 462 at 1325.


\textsuperscript{474} *In re Snowshoe Co.*, 789 F.2d 1085 at 1088 (4th Cir. 1986); *In re 495 Central Park Avenue Corp.*, 136 B.R. 626 (Bankr. S.D.N.Y. 1992); *cf. In re Couse Group, Inc.*, 71 B.R. 544 at 550 (Bankr. E.D. Pa. 1987), *affd* 75 B.R. 553 (E.D. Pa. 1987), where the court was "unconvinced that the Debtors have made the requisite exhaustive unsuccessful efforts to obtain credit on terms in accordance with s. 364(b). Only one lending institution was approached . . ." [at 550].

\textsuperscript{475} *In re Gloria Manufacturing*, 65 B.R. 341 at 348 (Bankr. E.D. Va. 1985). The court in this case found that "the business was to continue as an operation" and accordingly, granted *nunc pro tunc* leave to borrow [at 348].

As security provided to a new creditor under subsection 364(c) is subordinate to the claims of existing secured creditors or on unencumbered property of the estate, the new security does not impair the interests of preexisting secured creditors. Thus, there is no necessity to adequately protect the interest of a preexisting secured creditor. However, under subsection 364(d), the court may authorize the trustee to obtain credit or incur a debt by granting a security interest in property that is senior or equal to a preexisting encumbrance. The trustee, in seeking authorization for this type of transaction, must show that a credit facility on less onerous terms was unavailable and that the interest of the existing creditor is adequately protected. Clearly, this is the type of security that any postpetition lender would want, but the trustee must show that other potential creditors are unwilling to lend on less onerous terms.

Under subsection 364(d), the trustee has the burden of showing the method and adequacy of the proposed protection and the courts have shown a reluctance to authorize this type of transaction because of a potential decline in value of the collateral. As with all issues involving adequate protection, the courts attempt to strike that seemingly elusive balance between the rights of the debtor to reorganize its affairs and rehabilitate itself with those of the preexisting creditor to the benefit of its bargain. The courts must attempt to place a value on the collateral, considering such qualitative factors such as the nature of the business of the debtor, the prospects for a successful reorganization, the existence or lack of an equity cushion, and the likelihood that the collateral will depreciate or

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477 Norton Bankruptcy Law & Practice s. 38:6.
478 Code s. 364(d)(1)(A).
479 Code s. 364(d)(1)(B).
480 Code s. 364(d)(2).
481 See e.g., Anchor Savings Bank FSB v. Sky Valley, Inc., 99 B.R. 117 at 123 (Bankr. N.D. Ga. 1989), where the court expressed its concern that "some creditor which bargained for its first priority position will always be nudged aside."
482 In re O'Quinn, 98 B.R. 86 at 89 (Bankr. M.D. Fla. 1989).
appreciate. The parties place evidentiary matters before the court, which requires them to address valuation issues.

Subsection 364(e) protects a creditor who has granted credit or advanced funds on the strength of a court authorized priority or security interest, in the event that a court overturns the original authorization on appeal.\(^{483}\) The creditor will receive this protection, provided there was no stay of the original authorization, pending appeal, and the granting of the credit or the advancing of the funds was done in good faith,\(^{484}\) whether or not the creditor knew of the pending appeal.\(^{485}\) Failure to show the foregoing may result in the creditor losing the protection afforded by subsection 364(e) and having the administrative expense priority or security taken away.\(^{486}\)

A "controversial"\(^{487}\) practice has developed where a prepetition creditor attempts to cross-collateralize its prepetition debt with postpetition assets. This practice developed under the Chandler Act and is described as follows:

[This appeal] concerns a practice euphemistically called "cross-collateralization." . . . What this term means is that in return for making new loans to a debtor in possession under Chapter XI, a financing institution obtains a security interest on all assets of the debtor, both those existing at the date of the order and those created in the course of the Chapter XI proceeding, not only

\(^{483}\) The rationale underlying this provision is:

". . . to overcome people's natural reluctance to deal with a bankrupt firm whether as purchaser or lender by assuring them that so long as they are relying in good faith on a bankruptcy judge's approval of the transaction they need not worry about their priority merely because some creditor is objecting to the transaction and is trying to get the district court or court of appeals to reverse the bankruptcy judge. The proper recourse for the objecting creditor is to get the transaction stayed pending appeal." [In re EDC Holding Company, 676 F.2d 945 at 947 (7th Cir. 1982)].

\(^{484}\) In re Ellingsen MacLean Oil Co., 834 F.2d 599 (6th Cir. 1987)

\(^{485}\) Code s. 364(e). See e.g., In re Ellingsen MacLean Oil Co., ibid.

\(^{486}\) See e.g., In re EDC Holding Company, supra note 483 at 947 where the court took away the special priority of the lender on the grounds that it lacked good faith when advancing funds under the approval order.

\(^{487}\) Norton Bankruptcy Law & Practice s. 87:22.
for the new loans, the propriety of which is not contested, but for existing indebtedness to it.\textsuperscript{488}

Cross-collateralization gives a preference to a creditor that is undercollateralized or unsecured at the time the petition is filed. The Code invalidates most after-acquired property clauses in prepetition security agreements.\textsuperscript{489} Thus, any attempt by a prepetition undersecured creditor to obtain a security interest in postpetition property, that would otherwise be available for unsecured creditors, not only gives the undersecured creditor a preferred position, but also may be a violation of subsection 552(a) of the Code which provides:

\ldots property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

Furthermore, the trustee has the power to avoid an unauthorized transfer of property that occurs after commencement of the case.\textsuperscript{490} Subsection 547(b) of the Code describes the elements of a voidable preference as follows:

Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property -

(1) to or for the benefit of a creditor;
(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) made while the debtor was insolvent;
(4) made -
   (A) on or within 90 days before the date of the filing of the petition; or
   (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
(5) that enables such creditor to receive more than such creditor would receive if -
   (A) the case were a case under chapter 7 of this title;
   (B) the transfer had not been made; and
   (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Except for the periods set forth in paragraph 547(b)(4), a transaction involving cross-collateralization falls within the description of a voidable preference. Taken in combination with the trustee's

\textsuperscript{488} \textit{In re Texlon Corporation}, 596 F.2d 1092 at 1094 (2d Cir. 1979).

\textsuperscript{489} Code s. 552(a).

\textsuperscript{490} Code s. 549.
authorization to avoid postpetition transfers, one must question whether the court, in authorizing a cross-collateralization transaction, is participating in the facilitation of a preference in favour of the formerly undersecured or unsecured creditor.

The Code excepts, from the preference sections, transactions for "new value" which include money and money's worth in goods, services or new credit.491 The approval of cross-collateralization agreements may be justified on the basis that the estate receives new value (in the form of the new advance or the extension of new credit) and the Code does not specify that the new value bear a reasonable relative value to the postpetition security.492 In other words, the Code does not measure the value of the consideration given for the new value and accordingly, cross-collateralization may be legitimate consideration for the new value.

There is a division in the American bankruptcy courts concerning the issue of the legitimacy of a cross-collateralization transaction. The courts that have approved this type of transaction appear to view it as the only available means of providing the debtor an opportunity to reorganize, rehabilitate itself and avoid liquidation.493 The courts consider the adequacy of the notice given to the affected creditors and the "extent" of the preference.494 The latter part of the test appears to suggest that the courts examine the quantum of the new credit against the amount of the prepetition claim sought to be

491 Code ss. 547(a)(2) and 547(c).

492 Cf. BIA s. 97, which protects transfers by the bankrupt that are made for "adequate valuable consideration" from avoidance as a preference or settlement. Subsection (2) of that section defines adequate valuable consideration as "a consideration of fair and reasonable money value with relation to that of the property conveyed, assigned or transferred.

493 In re Ellingsen Maclean Oil Co., supra note 484; In re Adams Apple Inc., 829 F.2d 1484 (9th Cir. 1987). In the latter case, the court expressed the policy underlying its decision to uphold the validity of the cross-collateralization:

"Cross-collateralization clauses may provide the only means for saving a failing company. . . . If the lender is the sole lender willing to finance the debtor, a cross-collateralization clause may be the difference between an ongoing enterprise and a company in liquidation." [at 140].

Several commentators have criticized the authorization of cross-collateralization.496 The recent decision in In re Saybrook,497 may satisfy the critics. Saybrook held that cross-collateralization is an impermissible method of securing the postpetition financing in a reorganization proceeding, as it is inconsistent with the fundamental policies underlying the Code, including the policy of treating creditors of the same class equally.498 Because of this conflict with the fundamental policies of the Code, the courts could not exercise their equitable powers to authorize such a transaction, in violation of the Code's priority and distribution schemes.499

Saybrook imposed an absolute prohibition on cross-collateralization transactions. Whether this approach is appropriate will undoubtedly be the subject-matter of future debate.500 The fundamental questions are whether preferential transactions are inherently evil and whether the courts should disallow them under all circumstances, as suggested in Saybrook. Although the quantum of the consideration, as used in the BIA501 may provide an answer, that answer does not account for the policies underlying a reorganization regime. If the fundamental policies require a balancing of the interests of the debtor in reorganization and rehabilitation against those of the creditors and the equality of treatment of the creditors, a more flexible approach may be preferable. That is, preferences

495 Norton Bankruptcy Law & Practice s. 87:22.
496 See e.g., R.C. McCullough, "Analysis of Bankruptcy Code Section 364(d): When will a Court Allow a Trustee to Obtain Postpetition Financing by Granting a Superpriority Lien?" (1988) Com. L.J. 186, where the author stated that the concept of cross-collateralization "violates the spirit of the Code" and that it should only be allowed in the most extraordinary circumstances, if any [at 210].
497 963 F.2d 1490 (11th Cir. 1993).
498 Ibid. at 1494-1496.
499 Ibid. at 1495.
500 The debate appears to have started with a recent article referred to earlier, see Rickert, supra note 458.
501 Supra note 492.
possess an inherently distasteful quality, but if the preference will ultimately result in a reorganized debtor that enhances the realization prospects of all creditors, perhaps the preference is not so evil as it first appears. The creditors can give the court guidance in this regard. That is, should all affected creditors approve of the granting of the preference, this may show their support for the broader policy of the legislation. On the other hand, the court should be wary of any transaction to which the affected creditors object.

The intent of the preferred creditor may also be a relevant consideration. Under the BIA, the court may uphold a preferential transaction if the creditor can show that it advanced the funds with the bona fide expectation that the debtor would continue in business and solve its financial difficulties. Should the creditor honestly believe that its new value, however secured, will allow the debtor to reorganize itself for the benefit of all creditors of the estate, the court should consider this factor. This introduces the final factor that the court may consider, which is the likelihood of a successful reorganization. If it appears that the debtor is doomed to failure, on an objective analysis, this may imply that the preferred creditor did not necessarily have altruistic intentions.

Neither the BIA nor the CCAA contains provisions allowing for the borrowing of funds and the granting of security by the debtor, monitor (under the CCAA) or the proposal trustee (under the BIA). The absence of any such provision has resulted in the debtor using previously pledged accounts receivable and inventory to finance the proceeding. The courts under the CCAA have limited the right to borrow and grant security in priority to existing charges by requiring the consent of the affected creditors. Recently, the British Columbia Supreme Court allowed a postpetition creditor to take security on certain unencumbered assets of the debtor. This strategy is not unlike the security

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503 The concerns with this method of proceeding are discussed supra notes 448 to 452 and accompanying text.

504 In the context of a receivership, see Bank of America Canada v. Willam Investments Limited (1993), 20 C.B.R. (3d) 223 (Ont. Gen. Div.)
allowed under paragraph 364(c)(2) of the Code. The court exercised its inherent jurisdiction in granting the order. Because of the flexibility of the CCAA, the courts are in a position to fashion financing orders appropriate to the circumstances. In so doing, the courts should analyze the facts against the policy objectives of the CCAA.

The BIA only permits financing at the instance of an interim receiver. The appointment of an interim receiver may be detrimental to the reorganization efforts of the debtor, because of the costs of the interim receiver and its advisors and the possible loss of control by the debtor. The debtor must therefore weigh these detrimental effects against the necessity for financing.

Section 47.2 of the BIA permits the court to make an order with respect to payment of the fees and disbursements of an interim receiver, including an order granting the interim receiver a charge on assets of the debtor to secure the fees and disbursements that ranks ahead of existing secured creditors. Subsection 47.2(2) removes from the term "disbursements," payments made in operating the business of the debtor. Although one writer suggested that section 47.2 of the BIA neither allows nor prohibits the right of an interim receiver to seek a first charge on assets of the debtor for operating expenses, it is arguable that subsection 47.2(2) creates that prohibition.

Subsection 31(1) of the BIA provides:

(1) With the permission of the court, an interim receiver or a trustee, prior to the appointment of inspectors, may make necessary or advisable advances, incur obligations, borrow money and give security on the property of the debtor in such amounts, on such terms and on such property as may be authorized by the court and those advances, obligations and money borrowed shall be repaid out of the property of the debtor in priority to the claims of the creditors.

This subsection appears to apply only where the court has appointed an interim receiver during the period between the filing of a petition for a receiving order and the granting of the order. However, it may be much broader. Inspectors are appointed only after the court has granted a receiving order in a


506 K. Ham, "Corporate Restructuring Under Part III of the Bankruptcy and Insolvency Act" in Corporate Restructuring (Toronto: Canadian Institute, 1992) Tab III at 35.
liquidation proceeding, which may lead one to the foregoing conclusion. However, the words "prior to the appointment of inspectors" modify the word "trustee" and do not refer to the interim receiver.

Thus, an interim receiver, whether appointed prior to a receiving order in a liquidation proceeding or in a proposal proceeding has the powers set forth in subsection 31(1) of the BIA. The balance of the section does not suggest a similar conclusion, as those provisions refer only to the "bankrupt" or "trustee." Accordingly, those powers, duties and limitations are applicable only in a liquidation scenario. Those subsections provide:

(2) For the purposes of giving security under section 427 of the Bank Act, the trustee or interim receiver if authorized to carry on the business of the bankrupt is deemed to be a person engaged in the class of business previously carried on by the bankrupt.

(3) The creditors or inspectors may by resolution limit the amount of the obligations that may be incurred, the advances that may be made or moneys that may be borrowed by the trustee and may limit the period of time during which the business of the bankrupt may be carried on by the trustee.

(4) All debts incurred and credit received in carrying on the business of a bankrupt are deemed to be debts incurred and credit received by the estate of the bankrupt.

The leading treatise on bankruptcy law in Canada has suggested that:

Security given by an interim receiver on the assets of the debtor to obtain loans is subordinate to the claims of secured creditors. An interim receiver should, therefore, satisfy himself that there is sufficient equity in the pledged assets to cover the amount borrowed by him, or in the alternative, he should obtain the agreement of secured creditors to the subordination of their claims to the borrowing by the interim receiver.507

With the greatest respect, subsection 31(1) of the BIA does not suggest that conclusion. In fact, the closing words of that subsection require the interim receiver or trustee to repay the advances made and the obligations incurred "in priority to the claims of the creditors." Section 2 of the BIA defines the term "creditors" as including secured creditors. Thus, the court can only authorize the interim receiver to borrow or incur obligations on security that takes priority over existing security. The courts may be more inclined to grant such security if adequate protection is provided to existing secured creditors.

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3. Conclusion

Do the various provisions accomplish the objectives of the legislative regimes? If the objective of the regime is to encourage rehabilitation and reorganization of the debtor and treat creditors fairly and equitably, the Code substantially accomplishes that objective. The hallmark of the American system is to provide adequate protection to parties with an interest in the collateral. The absence of this concept in Canada limits the options of a debtor seeking to reorganize. Although one may question the adequacy of the protection granted to secured creditors in the United States, given their apparent discontent as exhibited by the volume of litigation and commentaries on the issue, the system is fairer to parties with an interest in the collateral than a system that allows the debtor to use the collateral with no compensation or protection being accorded to the affected party, as is presently the case in Canada.

The intervention of an interim receiver under the BIA to seek financing is an unnecessary and an unreasonable requirement. It is subjecting an already insolvent debtor to further costs that neither contribute to the going-concern value nor assist in the debtor's reorganization efforts. The requirement for an interim receiver is especially onerous in a situation where the creditors and the debtor are working together to reach an amicable solution to their mutual difficulties.

If the policymakers provide the courts with sufficient flexibility concerning issues, such as adequate protection and cross-collateralization, the circumstances will dictate what is fair. In sum, the flexibility of the CCAA is the most desirable system. This is especially evident in cases where the courts have adopted some of the more appealing concepts used in the United States, such as in the Westar case.508 The BIA is not workable, given the requirement for the intervention of an interim receiver. If an objectives of the BIA is to encourage proposal proceedings, the system has failed.

508 Supra note 505.
CHAPTER VI

MOVING TOWARD CONFIRMATION OF A PLAN OF REORGANIZATION

The objective of a proponent of a plan of reorganization is to formulate a plan that the creditors, the holders of the equity interests in the debtor and the court will accept. In moving toward this objective, the three statutory schemes may appear to be facially similar, in some respects, and the issues encountered often have a similar focus. However, the legislative schemes have fundamental differences which go to the very root of the reorganization process. In addition, the courts interpreting the seemingly similar mechanisms, take divergent approaches.

This chapter will examine certain issues that arise during the movement toward confirmation of the reorganization plan. The steps preceding confirmation will be briefly presented. This will allow the reader to contextualize the discussion of specific issues that follow. We will then consider the time within which a plan proponent must submit the plan of reorganization. This may provide us with some idea of the overall views of the policymakers and the judiciary of the reorganization process.

As a prelude to an examination of the issues surrounding the classification of creditors under each statutory regime, we will examine the voting acceptance requirements and how these requirements affect the classification of claims and interests. Classification of claims and interests under the plan is perhaps the most important matter for consideration of the plan proponent. Classification will determine whether the creditors and equity interest holders will accept the plan.

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1 A detailed outline of the mechanical steps leading toward confirmation would not contribute to an examination of the issues being considered in this paper. The reader is referred to subchapter II of chapter 11 of the Code, division I of part III of the BIA and part I of the CCAA, which set forth the steps leading to confirmation, as well as the many excellent treatises and articles which provide explanations of these steps, such as L.W. Houlden and C.H. Morawetz, Bankruptcy and Insolvency Law of Canada 3d ed. (Scarborough: Carswell 1993) at 2-122 - 2-128; D.H. Goldman, D.E. Baird, Q.C., and M.A. Weinczok, "Arrangements Under the Companies' Creditors Arrangement Act" (1991), 1 C.B.R. (3d) 135; J.D. Honsberger, Debt Restructuring (Aurora: Canada Law Book, 1993); P.F. Coogan, "Confirmation of a Plan Under the Bankruptcy Code" (1982) 32 Case W. Res. L. Rev. 301; Norton Bankruptcy Law and Practice, vol. 4.
before the plan proponent submits it to the court for confirmation. For the plan proponent, the matter of classification is more of an art than a science and the approach that the courts take in determining whether to approve the classification is based more on the policy objectives of the legislation than on an analysis of the commonality of interests among the members of the class.

Finally, this chapter will examine the much-misunderstood concept of the so-called "cram down" mechanism under the Code. The concept, as used in the United States, does not presently exist in Canada under the BIA or the CCAA. We will examine cram down to clarify the concept and determine the desirability of incorporating it into Canadian reorganization practice.

A. Steps Preceding Confirmation

Under the Code, once the plan proponent has negotiated a satisfactory plan with the parties in interest, it must provide the plan or a summary, along with a written disclosure statement, the contents of which the court has approved, to all claim and interest holders. The Code outlines the disclosure statement requirements as part of the provisions governing the solicitation of acceptances or rejections.


"I think it relatively clear that a court would not sanction a plan if the effect of doing so were to impose it upon a class, or classes, of creditors who rejected it. Such a sanction would be tantamount to the kind of unfair confiscation which the authorities unanimously indicate is not the purpose of the legislation." [at 18].

3 In this chapter, the term "plan proponent" will refer to the party putting forth the reorganization plan for consideration by the creditors and the equity interest holders. Although in most instances, the plan proponent will be the debtor, it appears that all of the statutory schemes being reviewed provide that persons other than the debtor may propose a plan. Section 50(1) of the BIA allows an insolvent person, bankrupt or trustee of the estate of a bankrupt or a receiver or liquidator of the property of an insolvent person to file a proposal. The CCAA is less clear in this regard but it refers to a compromise or arrangement "proposed between a debtor company and its [secured and unsecured] creditors" [CCAA ss. 4 and 5], without specifying who is authorized to put forth the plan. However, the meeting to consider the compromise or arrangement may be ordered at the instance of the debtor, a creditor, a trustee under the BIA or a liquidator. Finally, the Code provides the debtor with an exclusive time period within which to file a plan and thereafter, any party in interest is authorized to file a plan [Code s. 1121].

4 Code s. 1125(b).
of the plan. The disclosure statement must contain "adequate information" in that it must provide the voting parties with sufficient information to allow them to make an informed decision to accept or reject the plan. However, nonbankruptcy or state law does not govern the standard of disclosure. The court may, however, consider the standards used by the nonbankruptcy or state agencies to determine the adequacy of the information.

Following the solicitation of acceptances or rejections, the parties in interest vote on the proposed plan. The plan proponent provides a ballot to each party in interest along with the plan and the disclosure statement. The Code provides that if at least two-thirds in amount and one-half in number of the allowed claims of the class vote in favour of the plan, the plan is accepted by that class. Only votes of creditors actually voting are considered in determining whether the requisite

5 Code s. 1125(a)(1) defines "adequate information" as:

"... information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan, but adequate information need not include such information about any other possible or proposed plan;"

The court is given discretion as to the actual content of the disclosure statement and the adequacy of the information contained therein, see Valley National Bank of Arizona v. Trustee, 609 F.2d 1274 (9th Cir. 1979); In re Brandon Mill Farms Ltd., 37 B.R. 190 at 191 (Bankr. N.D. Ga. 1984). The definition of adequate information and the flexibility exercised by the courts in interpreting the definition allows the courts to develop the adequacy of the information contained in the disclosure statement on a case by case basis. This appears to reasonable inasmuch as different types of cases will require different levels of disclosure. For example, a publicly-held multinational real estate conglomerate will require and be able to afford a disclosure statement containing more elaborate and sophisticated information than a closely-held company which operates a corner grocery store.


7 Code s. 1125(d). Nonbankruptcy or state law, such as securities legislation prescribe standards of disclosure for altogether different purposes, such as for seeking equity financing.

8 Ibid.

9 Hopper, supra note 6 at 507.

10 Code s. 1126(c).
majorities have accepted the plan. For a class of equity holders to accept the plan, at least two-thirds in amount of the allowed interests that have voted must vote favourably.11 If solicitation or procurement of votes of an entity were not in good faith or if the votes of an entity were not cast in good faith, the courts will disregard those votes.12

The Code creates a presumption concerning acceptance or rejection of the plan with respect to two types of classes of claims or interests. It conclusively presumes acceptance of the plan by a class and the members of the class that remain unimpaired13 under the plan and the plan proponent need not attempt to solicit acceptance from that class.14 Conversely, the Code presumes that a class rejects the plan, if the plan provides that the class members will not retain or receive any property under the plan.15

Following acceptance of the plan, there is a hearing to determine whether the court will confirm the plan.16 In the event that all classes have accepted the plan,17 the court may confirm the plan under subsection 1129(a) of the Code.18 If, however, all classes have not accepted the plan, the court may nevertheless confirm the plan, provided at least one impaired class of claimants has

11 Code s. 1126(d).

12 Code s. 1126(e).

13 See Code s. 1124. The concept of impairment is defined, infra note 117.

14 Code s. 1126(e).

15 Code s. 1126(g).

16 Code s. 1128(a).

17 Code s. 1129(8).

18 In addition to the requirement that the plan be accepted or deemed accepted by the required majorities, Code s. 1129(a) sets forth a number of other requirements that must be met in order to confirm a "consensual plan. These include very broad, general requirements, such as the requirement that the plan comply with the Code and that the plan be proposed in good faith, technical requirements, such as the requirement for the payment of fees and the approval by governmental regulatory commissions of proposed rate changes, and substantive requirements or threshold standards that the plan must meet in order to be confirmed. The substantive requirements will be discussed infra notes 241-246.
accepted the plan.\textsuperscript{19}

The CCAA does not set forth the comprehensive procedural and substantive matters that the Code addresses and accordingly, case law has established most procedural matters. The CCAA is unique in contemplating that the first application is the one seeking an order summoning a meeting of creditors, class of creditors or shareholders of the company.\textsuperscript{20} The wording of the CCAA contemplates the existence of a compromise or arrangement between the debtor and its creditors at the time of the initial application.\textsuperscript{21} However, in most instances, because of the urgency of the matter, the debtor company will seek an order summoning the meeting, granting a stay of proceedings and providing a time within which a compromise or arrangement must be filed.\textsuperscript{22} The plan will set forth a description of classes of creditors for voting purposes. Although the CCAA does not provide any guidance to the debtor concerning the method or criteria for the classification of creditors, clearly, it permits the debtor

\textsuperscript{19} Code ss. 1129(b) and 1129(a)(10). Confirmation of the plan over the objection of the dissidents is known as "cram down" which will be fully explored in chapter VI(D), below. Subsection 1129(b) provides, in part, that a court may invoke the cram down provisions set forth therein "if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan". Rather than examining the substantive provisions of subsection 1129(a), at this juncture, such examination will be undertaken in the context of the cram down.

\textsuperscript{20} CCAA ss. 4 and 5.

\textsuperscript{21} The opening words of ss. 4 and 5 of the CCAA are "Where a compromise or an arrangement is \textit{proposed} between a debtor company" and its creditors [emphasis added], which suggests the existence of a compromise or arrangement at the time of the initial application.

\textsuperscript{22} For example, in the CCAA case involving Olympia & York Developments Limited, the order of the Ontario Court of Justice (General Division) granted on May 14, 1992 (Court File No. B125/92) provided:

"3. THIS COURT ORDERS that the applicants be and are hereby authorized and permitted to file with this Court, on or before July 13, 1992 or such later date as may be ordered by this Court, a plan of compromise or arrangement (the "Plan") between, \textit{inter alia}, the Applicants and their secured and unsecured creditors as they deem appropriate including, pursuant to Section 3(b) of the Act, a compromise or arrangement between each of the Applicants and the holders of bonds issued pursuant to a trust deed running in favour of a trustee, executed by each of the Applicants."
to classify its creditors for voting purposes.\(^{23}\)

The court will usually direct the proponent to send an information circular to all parties affected by the plan.\(^{24}\) The circular, which may be a part of the plan itself, will describe the plan and the financial and other information that will allow the creditors to make an informed decision concerning the feasibility and attractiveness of the plan.\(^{25}\) A proof of claim form, proxy, ballot and notice of meeting of the creditors usually accompany the information circular and the plan provided to the creditors.\(^{26}\) The CCAA does not specify the procedural aspects of the meeting of creditors, although separate meetings of the classes of creditors are not necessary so long as the classes vote separately.\(^{27}\)

Creditors or a class of creditors are considered to have accepted the plan if a majority in number representing three-fourths in value vote favourably.\(^{28}\) Calculation of the requisite majorities is based on those that actually vote on the proposed plan, either in person or by proxy.\(^{29}\) Unlike the Code, there is no provision in the CCAA that presumes rejection or acceptance of the plan by the creditors or a class of them. A determination of acceptance or rejection is made purely on the votes

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\(^{23}\) The opening words of section 6, for example, provide "Where a majority in number representing three-fourths in value of the creditors, or class, as the case may be..." [emphasis added]. The issue of classification under the CCAA will be explored in chapter VI(C)(2), below.

\(^{24}\) Goldman, Baird and Weinczok, *supra* note 1 at 156.

\(^{25}\) B.P. O'Lear, "A Review of the Companies' Creditors Arrangement Act" (1987) 4:3 National Insolvency Review 38 at 40. The circular will include information sufficient to meet the disclosure requirements under provincial legislation if the debtor is a publicly-held company

\(^{26}\) *Ibid.* at 40.

\(^{27}\) *Re Wellington Building Corporation Limited* (1934), 16 C.B.R. 48 at 54 (Ont. S.C.).

\(^{28}\) CCAA s. 6.

\(^{29}\) *Ibid.; Re Alabama, New Orleans, Texas & Pacific Junction Railway Co.* [1891] 1 Ch. 213 at 245 (C.A.). See also *Re Bilton Brothers Limited* (1939), 21 C.B.R. 79 (Ont. S.C.), where Urquhart J. reluctantly held that even though the class may be considered to have rejected the plan based on the claims filed, the plan had been accepted by those present and voting and as such, the plan was sanctioned.
cast in favour of or against the plan and the votes of the majority will govern the treatment of the entire class. The CCAA also has no provision for the cram down of the plan on dissenting classes of creditors. In other words, before the court will sanction a plan, the requisite majorities of each class must vote in favour of the plan.\footnote{Goldman, Baird and Weinczok, supra note 1 at 194.}

Should the requisite majorities accept the plan, the plan proponent will then apply for the court's sanction of the plan.\footnote{CCAA s. 6.} The court's initial concern is whether there has been substantial compliance with the words and spirit of the CCAA.\footnote{Re Dairy Corporation of Canada, [1934] 3 D.L.R. 347 (Ont. C.A.).} The court will look to the original order to ensure compliance with all procedural steps outlined in the order. It will also look to the plan and the procedures invoked in having the plan approved to satisfy itself that classification and voting were proper.\footnote{Re Northland Properties Ltd. (1988), 73 C.B.R. (N.S.) 171 at 182-183 (B.C.S.C.), aff'd (1988), 73 C.B.R. (N.S.) 195 (B.C.C.A.).} The substantive matters of concern to the court are whether the plan is fair and reasonable\footnote{Ibid.} and whether the creditors voting affirmatively for the plan did so in good faith.\footnote{See discussion, infra notes 134-151.}

Under the BIA, the plan proponent may commence the reorganization proceedings by filing the proposal itself with a licensed trustee.\footnote{BIA s. 50(2).} Alternatively, the plan proponent may file a notice of intention to make a proposal with the official receiver.\footnote{BIA s. 50.4(1).} Along with the proposal or, if the insolvent files a notice of intention to make a proposal, within 10 days after the filing of the notice of intention, the debtor must file a projected cash-flow statement with the official receiver.\footnote{BIA ss. 50(6); 50.4(2).} A trustee must review
the cash-flow statement and provide a report as to the reasonableness of the statement. The trustee's report is, similarly, filed with the official receiver. In the event that the debtor proceeds by filing a notice of intention to make a proposal, it has 30 days within which to file the proposal. The court may extend this period on the debtor's application. Subsection 50.5 requires the trustee named in the notice of intention to advise on, assist in negotiations of and participate in the preparation of the proposal. The intent of this provision is to interject a neutral third party between the debtor and its creditors that will, presumably, facilitate the making of an acceptable proposal.

The BIA's disclosure requirements are not so onerous as those of the Code and the CCAA. Paragraph 50(2)(a) provides that if the debtor is bankrupt, the plan proponent must file, along with the proposal, a copy of the statement of affairs prepared at the outset of the bankruptcy, setting forth the assets and liabilities of the bankrupt, along with a list of its creditors and particulars of any securities held by them. If the debtor is not bankrupt, a statement showing the financial position of the debtor at the date of the proposal must accompany the proposal. If the debtor files a proposal to commence the proceeding, a projected cash-flow statement must accompany the proposal. On the other hand, if the debtor filed a notice of intention to make a proposal and has already filed a projected cash-flow statement, it must file a revised projected cash-flow statement. Provided the court has not ordered the nondisclosure of the projected cash-flow statement under subsection 50(8), any creditor may

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39 Ibid.

40 BIA ss. 50.4(8) and (9). The timing for the filing of the proposal will be discussed in chapter VI(B), below.

41 BIA s. 158(d).

42 BIA s. 50(2)(b). See Jackson (Trustee of) v. Lowry (1987), 65 C.B.R. (N.S.) 261 (Ont. S.C.), which held that the filing of the statement showing the financial position of the debtor is mandatory, although the court permitted some flexibility in the form and substance of the statement.

43 BIA s. 50(6).

44 Ibid.
request a copy of the statement from the trustee.\footnote{45}

A meeting of creditors, called by the trustee, must be held within 21 days after the debtor files the proposal. The trustee must give each known creditor and the official receiver at least 10 days notice of the meeting.\footnote{46} A copy of the proposal, a condensed statement of the assets and liabilities, a proxy and a voting letter will accompany the notice of meeting.\footnote{47} The court may consider a meeting unnecessary, if it is clearly evident that a proposal cannot succeed.\footnote{48} The creditors vote by class.\footnote{49} However, the BIA, unlike the Code and the CCAA, provides that the proposal is accepted by the creditors "if, and only if," all classes of \textit{unsecured} creditors accept the proposal by a simple majority in number and two-thirds in value of those actually voting.\footnote{50} The proposal is binding only on secured creditors to whom the insolvent person makes a proposal and who accept the proposal by the same majorities as required in the case of the unsecured creditors.\footnote{51} This has the effect of allowing secured creditors to opt-out of the proposal process. Secured creditors that opt-out of the process may realize on their security, which defeats the objectives of the debtor in seeking to reorganize its affairs. Often, a secured creditor will maintain security on all or substantially all of the debtor's assets. If such a secured creditor rejects the proposal or opts-out, the proposal will likely not succeed, despite its theoretical acceptance by the unsecured creditors.

Before the court can approve the proposal under the BIA, the court must be satisfied that the

\footnote{45} BIA s. 50(7).
\footnote{46} BIA s. 51(1).
\footnote{47} \textit{Ibid}.
\footnote{49} BIA ss. 54(b) and 50(1.4).
\footnote{50} BIA s. 54(2)(d) [emphasis added].
\footnote{51} BIA s. 62(2)(b).
requisite majority of unsecured creditors has accepted the proposal and that the proposal is reasonable and calculated to benefit the general body of creditors. Although approval of the proposal by the court is discretionary, the BIA prescribes certain situations in which the court cannot approve it, such as where the proposal fails to provide for priority payments to the Crown, employees and the landlord under a lease that the debtor has repudiated.

The procedures that precede confirmation of a proposal are similar in all of the statutory schemes being examined. However, the acceptance thresholds, the means for establishing those thresholds and the absence of a cram down mechanism under both of the Canadian systems are obvious differences. In addition, the time within which the plan proponent may file the plan and the method of classifying creditors under each of the statutory schemes may also point to fundamental normative differences among the schemes.

B. The Time Within Which the Plan Must be Filed

Under the Code, the debtor has the exclusive right to file a plan, within the first 120 days of the case. If the debtor files the plan within the 120-day period, the debtor has an additional 60 days within which to secure acceptance of the plan. The Code terminates this "exclusivity period" if the court appoints a trustee, the debtor does not file a plan within the 120-day period, the debtor files a plan within the 120-day period but the creditors and the court do not accept it within 60 days.

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52 BIA s. 58.
53 BIA s. 59(2).
54 BIA s. 60(5).
55 BIA s. 60(1) to (1.5). See chapter V(B), above, for a full discussion of the rights of landlords under commercial leases. See also BIA s. 59(2) and (3).
56 Code s. 1121(b).
57 Code s. 1121(c)(3).
58 Norton Bankruptcy Law & Practice s. 88.1.
thereafter or the court abridges or extends the exclusivity period "for cause." Once the exclusivity period has terminated, any party in interest including the debtor, a creditor, the trustee, an equity security holder or a creditors' or equity security holders' committee may file a plan.

For the court to abridge or extend the exclusivity period, a party in interest must make the request within that period and not after it has expired. The applicant has the burden of showing cause for abridgment or extension. The Code does not define "cause." However, the legislative history provides some insight as to the legislative intent. The House Report suggested that court should consider factors such as the size of the debtor, delay by the debtor or recalcitrance among the creditors. The Senate Report suggested that the court should not grant extensions if they are merely

59 Code s. 1121(c) and (d). A discussion concerning the appointment of a trustee appears in chapter IV(A)(4), above.

60 Code s. 1121(c).

61 In re Perkins, 71 B.R. 294 at 297 (W.D. Tenn. 1987). If the motion is filed within the 120-day period but is scheduled to be heard following the expiration of that period, the issue may be moot [Norton Bankruptcy Law & Practice s. 88:3].

62 In re All Seasons Industries, Inc., 121 B.R. 1002 at 1004 (Bankr. N.D. Ind. 1990); cf. In re Manzey Land and Cattle Company, 17 B.R. 332 (Bankr. D.S.D. 1982), where the court granted the debtors extensions notwithstanding the expiry of the exclusivity period. This case was decided before the 1984 Amendments that added the following (emphasized) words to Code s. 1121(d):

"On request of a party in interest made within the respective periods specified in subsections (b) and (c) of this section and after notice and hearing, the court may for cause reduce or increase the 120-day period or the 180-day period referred to in this section."

63 House Report at 406. See e.g., In re Pine Run Trust, Inc., 67 B.R. 432 (Bankr. E.D. Pa. 1986), where the court granted a limited extension on the basis that the debtor was not unusually large and the issues to be dealt with were not sufficiently complex to justify a lengthy extension. Conversely, where the case involved complex issues, the court may be prepared to allow either a set period within which to file the plan or grant a number of short extensions, which would allow the court to closely monitor the progress of the debtor in formulating the plan [see e.g., In re Manville Forest Products Corp., 31 B.R. 991 at 995 (Bankr. S.D.N.Y. 1983), where the court permitted the debtor a number of extensions on the basis of the "sheer mass, volume and complications of the Manville filings." See also Re Texaco, Inc., 76 B.R. 322 (Bankr. S.D.N.Y. 1987), where the court also granted an extension and, in so doing, said ". . . in the history of this country there has never been a Chapter 11 case as large as the Texaco cases." (at 327); cf. the approach taken under the BIA which legislatively mandates short extensions on application. The approach taken in the BIA is discussed infra notes 69-72].

Delay in commencing the proceedings by the debtor has been used as the basis for abridging
used as a pressure tactic to force the parties to accept an unsatisfactory plan or if there is no probability that the plan proponent will formulate a plan of reorganization and have it accepted by the requisite majorities. Although the size and complexity of the case are relatively objective factors, the other factors cited by the legislative history suggest that the court consider the conduct of the parties. This type of analysis is not unlike the approach that the courts have taken in determining whether to grant a secured creditor relief from the automatic stay although again, one must question whether the court should punish the parties that would benefit from a reorganization on the basis of the misdeeds of the debtor or creditors.

A further question is whether 120 days is sufficient time to formulate a plan. One writer suggested that plan proponents frequently seek extensions "because most chapter 11 cases take significantly longer than 120 days to arrive at a fully negotiated plan." A complex case such as that the exclusivity period [see e.g., In re Texas Extrusion Corp., 844 F.2d 1142 at 1160 (5th Cir. 1988), cert. denied sub nom. Texas Extrusion Corp. v. Lockheed, 488 U.S. 926 (1988)]. Conversely, if the debtor has put forward a plan and the parties are in the process of negotiating its terms, the court may be willing to grant the extension sought by the debtor [Re Gibson & Cushman Dredging Corp., 101 B.R. 405 at 410 (E.D.N.Y. 1989).

64 Ibid. See e.g., In re Gogel & Gogel, 24 B.R. 674 (Bankr. S.D. Oh. 1982), where the court said that the "extension . . . would not only be fruitless, but probably counterproductive." [at 675]; cf. In re Manney Land and Cattle Company, 17 B.R. 332, where the court granted the extension over the strong objections of the sole secured creditor.

65 See e.g., In re Crescent Beach Inn, Inc., 22 B.R. 155 (Bankr. D. Me. 1982), where the court allowed the creditors' request for an abridgement of the exclusivity period on the following basis:

"... it appears that the major obstacle in the path to a successful reorganization in this case is the principal parties' acrimonious relations. They continue their bitter feuding not only at their own expense, but at the expense of all creditors of the debtor. Shortening the debtor's exclusive period for filing a plan will permit any party in interest, including parties with perhaps a more objective view of the debtor's circumstances, to file a plan." [at 161].

66 See discussion in chapter V(A)(4), above.

67 H. Karasik, "Extending the Debtor's Exclusive Right to File a Plan of Reorganization" (1985) 90 Com. L.J. 359 at 359. The writer does not provide statistics to support this statement or provide any details as to the types of debtors that seek extensions.
involving the Johns-Manville group of companies could justify an extension.\textsuperscript{68} However, debtors of this size and complexity are the exception rather than the rule, given the thousands of Chapter 11 cases filed each year. Therefore, in "most cases" the 120-day period should be sufficient time to formulate a plan. During this period, creditors may not enforce their rights, in the absence of an order lifting the automatic stay and, although secured creditors must be adequately protected during this period, one must question whether the protection is adequate in the view of secured creditors who frequently seek orders lifting the automatic stay.

If most cases under Chapter 11 take significantly longer than 120 days, one must also ask whether a proceeding under the BIA has any chance of resulting in a reorganization, when the maximum period within which a debtor may formulate a proposal is 6 months, including all discretionary extensions. Under the BIA, the insolvent person must formulate the proposal and file it with the official receiver within 30 days after the date it filed the notice of intention to make a proposal.\textsuperscript{69} The court may grant the debtor an extension of the 30-day period provided the debtor applies to the court within that period.\textsuperscript{70} If the court grants an extension and the debtor requires a further extension, it must apply before the expiration of the extension period previously granted.\textsuperscript{71} The court has a discretion to grant or deny the request for an extension and is limited to granting an extension not exceeding 45 days for any individual extension and not exceeding an aggregate of 5 months beyond the initial 30-day period.\textsuperscript{72}

\textsuperscript{68} Johns-Manville Corporation and 20 of its affiliates, including some of its international affiliates, filed reorganization petitions under Chapter 11. The consolidated debt was $600 million and consolidated liabilities were approximately $1 billion [L.A. Flyer, "Will Financially Sound Corporate Debtors Succeed in Using Chapter 11 of the Bankruptcy Act as a Shield Against Massive Tort Liability?" (1983) 56 Temple L.Q. 539 at 541-542 n. 11 and 12].

\textsuperscript{69} BIA ss. 50.4(8), 62(1) and 50.4(1).

\textsuperscript{70} BIA s. 50.4(9).

\textsuperscript{71} Ibid.

\textsuperscript{72} Ibid.
Unlike the Code, the BIA gives the courts some guidance in attempting to determine whether to grant the requested extension. To obtain an extension order, the debtor must satisfy the court that:

(a) it is acting in good faith and with due diligence;

(b) it would, in all likelihood, be able to make a viable proposal if the court granted the extension; and

(c) no creditor would suffer material prejudice if the court granted the extension.\(^73\)

Conversely, any interested party may seek to have the initial 30-day period or any extension terminated before its actual expiration based on:

(a) lack of good faith on the part of the debtor;

(b) absence of a likelihood that the debtor can make a viable proposal before the expiration of the period in question;

(c) absence of a likelihood that even if it could put forth a proposal within that period, whether viable or not, the proposal would be unacceptable to the creditors; or

(d) material prejudice to the creditors "as a whole" by continuation of the period in question.\(^74\)

The debtor must satisfy the court that all three criteria exist, to obtain the extension order.\(^75\) If however, a creditor is seeking to have the period in question terminated, it need only show one of the factors set forth in subsection 50.4(11). One of the factors is that the debtor has not acted or is not acting in good faith and with due diligence.\(^76\) Unlike the cases decided under the Code where the conduct of the debtor and its principals is a factor that the courts appear to consider covertly, the BIA

\(^{73}\) Ibid.

\(^{74}\) BIA s. 50.4(11).

\(^{75}\) BIA s. 50.4(9).

\(^{76}\) BIA s. 50.4(11)(a). See e.g., Re Malenfant (1992), 19 C.B.R. (3d) 295 (C.S. Qué.) [headnote only], where the court questioned the good faith of the debtor in obtaining extensions for the filing of a proposal using affidavits that contained "half-truths". [at 297].
requires the court to consider the conduct of the debtor. Whether the applicant is seeking an order extending or terminating the existing period, the court must consider the issue of the likelihood of the debtor being able to make a viable proposal. One of the first cases to deal with these provisions looked to the cases decided under the CCAA to determine the appropriate test. In High Street, the court held that to determine whether a proposal will be viable, "you must consider whether such proposal has a probable chance of acceptance." Relying on affidavit evidence of the debtor's president, stating that the debtor expected to receive an unconditional offer to purchase certain key assets of the debtor during the extension period, the court held that the objecting creditor could not say that it would not accept any proposal based on those facts. Accordingly, the court granted the order.

With respect, the court in High Street failed to apply the test upon which it purported to rely. Although the test required that the proposal must have "a probable chance of success," the court granted the extension to allow the debtor to formulate a proposal that had only a "possible" chance of acceptance, given the position of the objecting creditor. Knowing the facts, the secured creditor chose to object to the debtor's application for an extension. The creditor argued that during the extension period, it would suffer prejudice because of accruing interest and realty taxes. Presumably, the debtor's president was able to swear that the debtor was in a position to sell certain key assets based on negotiations that preceded the date of the application. If the price that the debtor was seeking for the assets satisfied the creditor, based on the present value of the creditor's claim against the debtor, it would not have objected to the application. However, it appears that the terms of sale were not satisfactory to the creditor. Accordingly, at best, there was nothing more than a possibility that the creditor would accept the proposal resulting from the sale and, in all likelihood, the creditor would

77 In fact, this was the primary basis for the decision in Re High Street Construction Ltd. (1993), 19 C.B.R. (3d) 213 at 215 (Ont Gen Div.) [hereinafter High Street]. If a proposal has no probable chance of acceptance, a court has no alternative but to dismiss the application for the extension, notwithstanding the bona fides of the debtor and its principals.

reject it. Thus, the court should have dismissed the debtor's application for an extension.\textsuperscript{79}

It will be recalled that to obtain an extension of the time within which to file the proposal, the debtor must show that it would likely be able to make a viable proposal if the court granted the extension.\textsuperscript{80} Conversely, an interested party could seek termination of the initial 30-day period or any extension on the basis that it is unlikely that the debtor will be able to make a viable proposal before the expiration of the period in question.\textsuperscript{81} In both situations, the issue is whether the debtor will be able to make a viable proposal. On the other hand, paragraph 50.4(11)(c) of the BIA provides that the court may terminate the initial 30-day period or any extension if "the insolvent person will not likely be able to make a proposal, before the expiration of the period in question, that will be accepted by the creditors." To apply this paragraph, the creditor need not address the issue as to the viability of the plan. All that is necessary is for the applicant to show that it is unlikely that the creditors will accept the plan. If a creditor applies for the termination of the period in question and advises the court definitively that it would not be prepared to accept any proposal put forth by the debtor unless it received payment in full as well as compensation for opportunity cost, the creditor has created a presumption that the debtor can rebut only by showing that it is "likely" that it could put forth and

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\textsuperscript{79} Similar reasoning was applied in \textit{Re Magasin Coop Dégelis}, (1993), 24 C.B.R. (3d) 49 (C.S. Que.) [headnote only], where a creditor applied to have the initial 30-day period terminated. In that case, the court held that the word "likely" does not require the debtor to prove beyond a reasonable doubt that it could put forth a proposal that would be accepted by the creditors. The debtor merely had to prove that it was "more than probable" that such a plan could be put forth. Even though the objecting creditor argued that it was unlikely that the debtor could put forth a proposal that would be accepted by the creditors, given that the creditor represented more than two-thirds in value of the unsecured creditors, the court dismissed the creditor's application on the basis that a "reasonable proposal could be accepted by the applicant." The court held further that an order terminating the thirty-day period was contrary to the spirit of the BIA and should be granted only in exceptional circumstances.

\textsuperscript{80} BIA s. 50.4(9)(b).

\textsuperscript{81} BIA s. 50.4(11)(b).
comply with a proposal including such a provision.\footnote{82}{In Re Baldwin Valley Investors Inc. (1994), 23 C.B.R. (3d) 219 at 221 (Ont. Gen. Div.) [hereinafter Baldwin Valley], the court made the distinction between the necessity of showing that a proposal was "viable" and a situation where the viability of the proposal is not in issue. In that case, the court refused to grant the debtor the requested extension, on the ground that it could not provide particulars of proposed third parties that would be willing to convert the current debt financing to equity financing. The court held that even if the debtor were successful in its argument as to the viability of its proposal, the fact that the creditor which held virtually all of the debt had lost total confidence in the debtor and merely wanted to enforce its security meant that the creditor simply had to bring a motion under paragraph 50.4(11)(c). In other words, the creditor need not wait for an additional period if it is confident that the debtor could not meet its demands.}

The time within which a debtor must formulate a proposal under the BIA is relatively short. Unless the debtor is prepared for the possibility of having to expeditiously file a notice of intention to make a proposal, it will be difficult for the debtor to formulate an acceptable proposal in such a short period. One must remember that the debtor, during that period, must attempt to operate the business. There will also be the added responsibilities of preparing the projected cash-flow statement and, in all likelihood, there will be endless meetings with accountants, lawyers, possible debt or equity participants and appraisers. In addition, the debtor must determine the type of arrangements that may be acceptable to key creditors to negotiate with them in a way that will ensure their support at the meeting. These activities take time and although the debtor may seek extensions, court applications take additional time and financial resources, which are scarce for an insolvent debtor. Although a debtor may obtain additional time through the filing of an assignment under the BIA, the stigma of bankruptcy and the total loss of control to a licensed trustee may cause the debtor irreparable harm.

It is interesting to note that the Tassé Report and the Colter Committee Report recognized that the debtor usually requires some period to formulate a proposal or plan of arrangement. Accordingly, the reports recommended that any reforms should allow the debtor to file a notice of intention to make a proposal, which would stay the rights of creditors and permit the debtor to formulate a plan or
The Tassé Report did not prescribe a time within which the debtor was to file the proposal, although it referred to the period as a "short stay of proceedings." The Colter Committee Report, on the other hand, recommended a period of 21 days. Ultimately, the BIA prescribed the period at 30 days, with a right to seek extensions from time to time. The Code and the CCAA provide the debtor with considerably more time. This is one further reason to question whether Canadian policymakers were committed to providing a readily accessible reorganization regime to debtors.

The CCAA prescribes no time periods within which the debtor must file a plan of compromise or arrangement. As the debtor will be formulating a plan during the period in which the stay of proceedings is operative, the period will correspond to the stay period. As such, the considerations concerning imposition and lifting of the stay of proceedings will apply equally to the issue of whether to allow the debtor time or additional time within which to formulate a plan. However, we should note that the discretion exercised by the court under the CCAA allows the flexibility necessary to prescribe a period that suits the debtor, giving due consideration to the situation and rights of the creditors. In so doing, the court should consider some of the same factors as under the BIA and the Code. In particular, the courts should be mindful of the periods prescribed by the BIA and the Code, which apparently reflect the intent of the policymakers in market economies that are the same as (in the case of the BIA) or similar to (in the case of the Code) the circumstances that the court is considering.

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83 Tassé Report at 91; Colter Committee Report at 56. The Colter Committee Report chose to identify the notice with the purpose it was meant to serve. That report called the document a "notice of stay."

84 Tassé Report at 175.

85 Colter Committee Report at 56.

86 BIA s. 62(8) and (9).

87 See discussion in chapter V(A)(4), above.
It is difficult to garner any general rules concerning the time periods granted by the courts under the CCAA. One author stated that "[s]tays of proceedings of sixty to ninety days on the initial application under the CCAA are not uncommon."88 Another author stated that "[u]nder the CCAA, courts will typically give the debtor 3-6 months to file a plan of arrangement."89 Actually, the courts appear to review the circumstances and prescribe a time based on those circumstances. The starting point for large, complex cases appears to be 6 months.90 Counsel treat 6 months as a starting point and will request that relief in the initial motion.91 The court will then decide whether that period is appropriate in the circumstances and may grant a shorter period, should the matter not be of a complex nature. In some instances, the court may grant a relatively short period within which to formulate a plan with leave to seek extensions from time to time.92 This has the advantage of allowing the court to monitor the progress of the debtor in formulating its plan of arrangement or compromise. The disadvantage for the debtor however, is the legal and other costs involved in having to report

88 M.J. MacNaughton, "Debtors' Strategies in Reorganizations" in Corporate Restructuring (Toronto: Canadian Institute, 1992) Tab V at 21.

89 K. Ham, "Corporate Restructuring Under Part III of the Bankruptcy and Insolvency Act" in Corporate Restructuring (Toronto: Canadian Institute, 1992) Tab III at 41.

90 E.g., the court, in the proceedings involving Olympia & York Developments Limited gave the company approximately 6 months within which to formulate a plan. A later decision in those proceedings described the company as follows:

"The Olympia & York group of companies constitute one of the largest and most respected commercial real estate empires in the world, with prime holdings in the main commercial centres in Canada, the U.S.A., England and Europe." [Olympia & York Developments Ltd. v. Royal Trust Co., supra note 2 at 3].

It should be noted that the debtor in that case actually formulated its plan within 7 months after the initial order. Both the creditors and the court approved the plan (as amended).

In the proceedings involving Quintette Coal Ltd., which was also a case of some complexity, the British Columbia Supreme Court granted the debtor a period of 6 months within which to formulate a plan.

91 See e.g., Diemaster Tool Inc. v. Zukov (1991) 3 C.B.R. (3d) 133 (Ont. Gen Div.) [hereinafter Diemaster].

92 See e.g., Timber Lodge Ltd. v. Imperial Life Assurance Co. (1992), 17 C.B.R. (3d) 126 (P.E.I.S.C.) [hereinafter Timber Lodge].
periodically to the court.93

The court in Re Perkins Holdings,94 took an alternate approach where it made no order concerning the time within which the debtor could formulate a plan, but allowed adjournments of the initial application. This allowed the debtor time within which to explore various alternatives. Finally, when it appeared that the debtor was making significant progress toward negotiating a sale of its operations as a going concern, the court ordered that a plan be prepared within 7 days of the date of the order. On its face, this decision appears harsh. However, as the court allowed the debtor almost 3 months to negotiate a sale that would allow it to put forth a plan, the decision is extremely fair.

The standards used by the courts in determining whether to terminate or grant an extension of the period to formulate a plan are, not surprisingly, the same as those used when considering whether to lift the stay of proceedings. The courts initially inquire into whether the debtor is making any progress toward the formulation of a plan.95 They then look at the prospects of a plan being formulated and approved by the creditors. There is a divergence of opinion in this regard. Elan96 and its progeny,97 stand for the proposition that if a major creditor that is in its own class or comprises the requisite majority within a class, advises the court that it will not accept a plan under any

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93 Timber Lodge, ibid., is a good example of this manner of proceeding. In that case, the court allowed the debtor time within which to formulate its plan with the condition that the debtor had to appear before the court periodically to report on the progress being made. If no progress was shown, the stay would be lifted. This procedure continued for a period of approximately 5 months, at which time the court determined that progress toward formulation of a plan had halted and accordingly, the stay was lifted.


95 See e.g., Icor Oil & Gas Co. Ltd. v. Canadian Imperial Bank of Commerce (No. 2) (1990), 102 A.R. 225 Alta. Q.B.), where the court granted the debtors' request for a 14-day extension on the basis that progress was being made toward the formulation of a plan. It did not appear to the court that circumstances would change significantly during the extension period. The court also noted the substantial effect on unsecured creditors which would result should the extension not be granted.

96 Elan, supra note 78.

circumstances, "[t]here is no useful purpose to be served in putting a plan of arrangement to a meeting of creditors if it is known that it cannot succeed."\textsuperscript{98} \textit{Phillip's}, on the other hand, required the creditor to satisfy the burden of proving that the debtor's prospect of making a compromise or arrangement is "doomed to failure" before the court will terminate the period.\textsuperscript{99} The creditor must satisfy the court that the debtor could not obtain financing or make other arrangements with another source that would facilitate a payout of the objecting creditor.\textsuperscript{100} This places a very heavy burden on the creditor.\textsuperscript{101}

The divergent approaches in \textit{Elan} and \textit{Phillip's} illustrate the antithetical interests at stake in attempting to balance the rights of the debtor and the objecting creditor. It is submitted that the court in \textit{Icor} examined the correct issue and, as part of that examination, considered the objectives of a reorganization statute. The issue considered by the court was whether the debtor was making progress toward the formulation of a plan. In reaching its decision, it not only weighed the interests of the applicants and respondents, but also considered the interests of third party creditors and the effect on them of vacating or maintaining the stay.

Finally, we should note that the courts, in dealing with extension applications under the CCAA, take an approach similar to that taken by the courts in the United States with respect to the conduct of the parties. Although the courts do not expressly mention the conduct of the parties as a factor to be considered, it is obvious, in some cases, that conduct is the primary factor governing the court's decision. In \textit{Perkins}, the court was impressed with the fact that "the company itself had recognized its financial problems and retained outside help in an attempt to resolve them."\textsuperscript{102}

\textsuperscript{98} \textit{Elan}, supra note 78 at 301.

\textsuperscript{99} \textit{Re Phillip's Manufacturing Ltd.}, (1992), 9 C.B.R. (3d) 25 (B.C.C.A.) [hereinafter \textit{Phillip's}].

\textsuperscript{100} \textit{Ibid} at 28.

\textsuperscript{101} It is interesting to note that in \textit{Hongkong Bank of Canada v. Chef Ready Foods Ltd.}, (1990), 4 C.B.R. (3d) 311 (B.C.C.A.), which was the case that originated the "doomed to failure" concept, the creditor ultimately succeeded in having the stay of proceedings lifted when it was shown that the debtor ceased operations.

\textsuperscript{102} \textit{Re Perkins Holdings}, supra note 94 at 306.
Conversely, in lifting the stay of proceedings, the court in *Timber Lodge* stated:

The applicant has stated that after the June 29th hearing it was too preoccupied with the appeal process to really put any effort into the restructuring plan. I am unable to accept such an argument.  

The period within which the plan proponent must formulate a plan reflects the policy underlying the reorganization regime. The approach taken by the legislation and courts in determining whether to terminate or extend the period is even more reflective. The BIA is very restrictive in these matters. We may speculate that the policymakers intended that only small, uncomplicated entities that would not require a protracted period within which to formulate a plan would use the BIA and that all other entities would use the CCAA. However, the BIA contains nothing that suggests that it is to be so limited. Should Parliament repeal the CCAA, the BIA is not a feasible solution for most complex reorganizations.

Although the Code provides a longer period for the debtor to formulate a plan, prescribing time periods may not be appropriate in some circumstances. Although in the case involving Olympia & York Developments Limited, the debtor put forth a plan within 7 months, one could contemplate cases of even more complexity that could take longer. Conversely, the 120-day period during which the debtor alone may formulate and file a plan under the Code may be excruciatingly long in the case of a small closely-held corporation.

Prescribing any type of period necessarily involves line-drawing that may not be appropriate in legislation intended for cases of differing size and complexity. The right to abridge or extend the prescribed periods may temper their strictness. However, the courts will inevitably use the prescribed periods benchmarks and the policy will evolve accordingly. While the parties have the advantage of knowing, with certainty, the periods that they are facing at the outset and may govern themselves accordingly, it is a waste of financial and other resources to require the parties to have to resort to the courts, from time to time, to deal with these issues if they recognize at the outset that the prescribed

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103 *Timber Lodge*, supra note 92 at 130.
periods are inappropriate.

In this manner, the system established under the CCAA is superior to those of the BIA and the Code. Although a rather strict regime is evolving under the CCAA, the courts still have the necessary flexibility to tailor the remedy to fit the circumstances. While the 6-month period is a benchmark for a debtor seeking relief under the CCAA, in appropriate circumstances, the court may provide a longer period, such as in the case of massive tort liability or environmental damage. In such a case, however, the court might allow the debtor the 6-month period with leave to reapply for extensions, from time to time. Conversely, the courts under the CCAA have reduced the requested 6-month period, in appropriate circumstances. Although in some cases the period is very short, the circumstances show that the debtor usually had sufficient time within which to formulate its plan.

Although the CCAA does not prescribe any time periods which may lead one to criticize it for its lack of predictability, the case law under the CCAA has established that predictability. Counsel should be familiar with the facts of the reported cases to provide sound advice to their clients. For unusual circumstances, the CCAA allows the necessary flexibility to fashion an appropriate remedy.

C. Classification and Voting on the Plan

Though chronologically, classification of claims takes place prior to voting on the plan of reorganization, this paper will first examine the voting procedure, and will thereafter examine the issue of classification. The reason for examining these issues in reverse chronological order is that the voting procedure may govern the classification of claims. Each of the statutory schemes requires the classes to accept the plan by prescribed statutory majorities. Neither of the statutory schemes used in Canada permits the cram down of a plan on rejecting classes. Under the CCAA, if a plan is rejected by a class, the court may not sanction the plan.104

104 CCAA s. 6 provides that once the statutory majorities have agreed to the compromise or arrangement, the court may sanction the plan. The courts have consistently held that the court cannot sanction a plan unless there has been strict compliance with all statutory requirements [see e.g., Re
Similarly, the BIA requires creditors to accept the proposal prior to the trustee applying to the court for approval.\footnote{BIA s. 58.} The BIA considers a proposal to be accepted by the creditors if and only if all classes of unsecured creditors vote in favour of the proposal by the requisite statutory majorities.\footnote{BIA s. 54(d).} Should secured creditors choose not to accept the proposal or if the debtor did not make a proposal to the secured creditors, they may simply proceed to realize on their security, unaffected by the balance of the proposal proceedings. As mentioned previously,\footnote{Supra note 50-51 and accompanying text.} the rejection of the proposal by secured creditors may effectively render the accepted proposal unworkable.

As the Canadian reorganization regimes do not allow the cram down of the plan on dissident classes, the debtor's objective is to minimize the number of classes, to dilute the voting strength of an individual creditor or group of creditors.\footnote{A similar concern has been raised in the context of the Code where it has been stated that the plan proponent "may attempt to 'rig' the vote by placing dissident claimants in a class whose other claimants can be counted on to support the plan and carry the vote." [D.A. Skeel, "The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases" (1992) 78 Va. L. Rev. 461 at 477].} For example, a plan that provides a separate class for each secured creditor provides each creditor an opportunity to exercise a veto over the plan. On the other hand, a plan that puts all secured creditors in one class may allow votes of subordinate secured creditors to dilute the votes of an objecting creditor with first rights to the collateral. The courts and the legislation in Canada show a preference against the creation of a multiplicity of classes.\footnote{See e.g., BIA s. 54(b)(i), which provides that the unsecured creditors shall constitute one class unless the plan proponent chooses to provide for more that one class of unsecured classes in the proposal. Similarly, the Alberta Court of Queen's Bench in Norcen Energy Resources Ltd. v. Oakwood Petroleum Ltd., [1989] 2 W.W.R. 566 (Alta. Q.B.), in reviewing the classification under a CCAA proceeding held that:

"To accept the 'identity of interest' proposition as a starting point in the classification of creditors necessarily results in a 'multiplicity of discrete classes' which would make any reorganization difficult, if not impossible, to achieve." [at 28].}
Classification is also important under the Code. To have a plan confirmed under the Code, whether under the provisions allowing for confirmation on the acceptance of all classes or under the cram down provisions, at least one impaired class of claims must accept the plan.\textsuperscript{110} Again, avoidance of a multiplicity of classes assists the debtor in attaining this threshold.\textsuperscript{111}

Accordingly, as a prelude to an examination of the classification issue and to appreciate the objectives of the debtor in seeking to avoid multiple classes and the creditors in challenging their placement in certain classes, this section will consider the voting requirements. We will then examine the criteria for classification, to determine whether the criteria adopted by the BIA are consistent with current approaches.

1. Voting on the Plan and Required Majorities

Under the Code, to accept the plan, at least two-thirds in amount and one-half in number of the members of the class whose claims are allowed\textsuperscript{112} must approve it.\textsuperscript{113} With respect to interest holders, at least two-thirds in amount of the allowed interests of such class who vote on the plan must approve it.\textsuperscript{114} In both cases, the court may disregard votes not cast in good faith or those procured in bad faith.\textsuperscript{115} With certain exceptions, the statutory majorities are calculated based on the actual

\textsuperscript{110} Code s. 1129(a)(10).

\textsuperscript{111} The courts in the United States similarly seek to avoid a multiplicity of classes. See e.g., \textit{In re Palisades-on-the-Desplaines}, 89 F.2d 214 at 217 (7th Cir. 1937).

\textsuperscript{112} Code s. 502 governs the allowance of claims or interests. Provided a claim or interest holder files a proof of such claim or interest in a timely manner and no party in interest objects, the claim is deemed allowed. The section goes on to provide for the procedure and matters to be considered should a party in interest object. This paper will not discuss the provisions concerning allowance or disallowance of claims. The reader is referred to the provisions of the Code in this regard.

\textsuperscript{113} Code s. 1126(c).

\textsuperscript{114} Code s. 1126(d).

\textsuperscript{115} Code s. 1126(e).
number of votes cast for or against the plan.\textsuperscript{116} The exceptions are the statutory presumptions that
deam a class to have accepted or rejected the plan. Subsection 1126(f) of the Code creates a
presumption of acceptance of the plan if the class remains unimpaired.\textsuperscript{117} Although the Code does not
expressly preclude an unimpaired class from voting, deemed acceptance is a conclusive presumption\textsuperscript{118}
and from a practical perspective, one could hardly expect an unimpaired class to reject a plan where
the rights and interests of the members of the class remain intact. Conversely, subsection 1126(g)
presumes rejection of the plan by a class, if the plan provides that the members of that class do not
retain or receive any property on account of their claims. Again, rejection is a conclusive

\textsuperscript{116} House Report at 410; Re Jeppson, 66 B.R. 269 at 294 (Bankr. D. Utah 1986).

\textsuperscript{117} Impairment of a class of claims or interests is discussed in section 1124 of the Code which
provides:

"Except as provided in section 1123(a)(4) of this title, a class of claims or interests is impaired
under a plan unless, with respect to each claim or interest of such class, the plan-
(1) leaves unaltered the legal, equitable, and contractual rights to which such claim
or interest entitles the holder of such claim or interest;
(2) notwithstanding any contractual provision or applicable law that entitles the
holder of such claim or interest to demand or receive accelerated payment of such
claim or interest after the occurrence of a default -
   (A) cures any such default that occurred before or after the commencement
   of the case under this title, other than a default of a kind specified in section
   365(b)(2) of this title;
   (B) reinstates the maturity of such claim or interest as such maturity
   existed before such default;
   (C) compensates the holder of such claim or interest for any damages
   incurred as a result of any reasonable reliance by such holder on such
   contractual provision or such applicable law; and
   (D) does not otherwise alter the legal, equitable, or contractual rights to
   which such claim or interest entitles the holder of such claim or interest; or

(3) provides that, on the effective date of the plan, the holder of such claim or
interest receives, on account of such claim or interest, cash equal to -
   (A) with respect to a claim, the allowed amount of such claim; or
   (B) with respect to an interest, if applicable, the greater of -
      (i) any fixed liquidation preference to which the terms of any
      security representing such interest entitle the holder of such interest; or
      (ii) any fixed price at which the debtor, under the terms of such
      security, may redeem such security from such holder.

\textsuperscript{118} Norton Bankruptcy Law & Practice s. 91:21.
presumption, although one would not expect such a class to accept a plan. The two-thirds majority refers to the dollar amount, in respect of claims, and the number of shares held by those voting, in respect of interests.

Prior to the 1984 Amendments, an issue arose as to whether deemed acceptance under subsection 1126(f) was sufficient to satisfy the requirement that one class of claimants must accept the plan before the court could invoke the cram down provisions. This issue, however, now appears to be moot, since paragraph 1129(a)(10) provides that, for the cram down to apply, "at least one class of claims that is impaired under the plan has accepted the plan." [emphasis added]. The 1984 Amendments however, did not resolve the issue of whether the class is deemed to have accepted the plan if no members of the class vote. In re Ruti-Sweetwater, Inc., held that the failure to vote

119 This conclusion is supported by the legislative history, see House Report at 411 and Senate Report at 123. The Senate Report stated that such a class "is conclusively deemed to have rejected the plan" and "[t]here is obviously no need to submit a plan for a vote by" that class. Even if the class votes to accept the plan, the court may disregard the acceptance. This is especially relevant in a case where the acceptance was obtained by questionable means to use the cram down provisions. See e.g., In re Waterways Barge Partnership, 104 B.R. 776 at 783 (Bankr. W.D. Miss. 1989).

120 Norton Bankruptcy Law and Practice s. 91:18. Skeel, supra note 108, undertakes a very interesting analysis of the normative concerns underlying voting by the shareholders in the context of corporate law as against those involved in a bankruptcy scenario. The author suggests that the one share, one vote approach in a nonbankruptcy scenario reflects the financial stake that a shareholder has in the corporation. Conversely, in a bankruptcy situation, the statutory majorities are an attempt by the policymakers to account for the differences in the origin and the amount of the claims of the creditors [at 488]. It is submitted, however, that the origin and amount of the creditors' claims are accounted for in the classification procedure. Subsection 1122(a), which will be discussed, supra notes 169-207 and accompanying test, requires that claims or interests within a class must be substantially similar. The statutory majorities attempt to balance the interests of the large claimholders by requiring the plan to be accepted by a two-thirds majority in amount and by giving the small claimholders some control by requiring that the plan be accepted by a majority in number.


122 The issue of classifying creditors in order to gerrymander votes will be discussed, infra notes 199-201 and accompanying text.

123 836 F.2d 1263 (10th Cir. 1988). The rationale for this holding was:

"To hold otherwise would be to endorse the proposition that a creditor may sit idly by, not participate in any manner in the formulation and adoption of a plan in reorganization and
should be considered to be an acceptance of the plan. However, *In re M. Long Arabians*\(^{124}\) came to a contrary conclusion.

Section 6 of the CCAA provides that the court may sanction a compromise or arrangement if a majority representing three-fourths in value of the creditors, or class of creditors, present and voting whether in person or by proxy, accept the compromise or arrangement at a meeting of the creditors called for that purpose.\(^{125}\) Like the situation under the Code, the CCAA calculates the statutory majorities with reference to only the creditors actually voting on the compromise or arrangement, either in person or by proxy.\(^{126}\) The rationale underlying this approach may be that stated by Stanley Edwards:

... it may be argued that it is reasonable to assume that those who do not vote are content to be bound by the decisions of those who do, and that under the C.C.A.A. and the Dominion Companies Act, the same principle should govern as in elections of labour union and legislative representatives, and as in democratic referenda. Because of the usual apathy of creditors and investors generally, it would otherwise be virtually impossible to effect a reorganization in many cases.\(^{127}\)

The dollar amount of the claims is used to calculate three-fourths in value threshold and the majority in number is calculated by counting the actual number of the creditors voting on the plan.\(^{128}\)

Classification of claims would be a fruitless exercise if the courts interpreted the CCAA as thereafter, subsequent to the adoption of the plan, raise a challenge to the plan for the first time. [This] approach would effectively place all reorganization plans at risk in terms of reliance and finality." [at 1266-1267].

\(^{124}\) 103 B.R. 211 at 215 (9th Cir. 1989).

\(^{125}\) CCAA s. 6.

\(^{126}\) *Supra* note 29. One author criticized the proxy system and suggested ways that the plan proponent could alleviate the concerns, see S.E. Edwards, "Reorganizations Under the Companies' Creditors Arrangement Act" (1947) 25 Can. Bar Rev. 587 at 609-611. One basis for his criticism was that section 6 allows for the modification or alteration of the plan prior to the vote being taken. Clearly, the claim holder, in such a case, is not in a position to consider the merits of the modified or altered plan and must necessarily entrust the voting rights with the proxy holder.

\(^{127}\) Edwards, *ibid.* at 612.

permitting all classes to vote as one group. Thus, each class must vote separately to determine whether the requisite majority of each class has accepted the plan.129

The provisions of the BIA governing acceptance or rejection of a proposal by the creditors130 are anomalous in at least two respects. First, acceptance of the proposal is based only on the votes of the unsecured creditors and the secured creditors to whom the proposal is made. This may result in the proposal being statutorily accepted, but not being binding on secured creditors who vote to reject the proposal.131

129 Re Wellington Building Corp., supra note 27.

130 BIA s. 54 provides:

(1) The creditors may, in accordance with this section, resolve to accept or may refuse the proposal as made or as altered at the meeting or any adjournment thereof.
(2) For the purpose of subsection (1),
(a) the following creditors with proven claims are entitled to vote:
   (i) all unsecured creditors, and
   (ii) those secured creditors in respect of whose secured claims the proposal was made;
(b) the creditors shall vote by class, according to the class of their respective claims, and for that purpose
   (i) all unsecured claims constitute one class, unless the proposal provides for more than one class of unsecured claim; and
   (ii) the classes of secured claims shall be determined as provided by subsection 50(1.4);
(c) the votes of the secured creditors do not count for the purposes of this section, but are relevant only for the purpose of subsection 62(2); and
(d) the proposal shall be deemed to be accepted by the creditors if, and only if, all classes of unsecured creditors vote for the acceptance of the proposal by a majority in number and two thirds in value of the unsecured creditors of each class present, personally or by proxy, at the meeting and voting on the resolution.
(2.1) For greater certainty, subsection 224(1.2) of the Income Tax Act shall not be construed as classifying as secured claims, for the purpose of subsection (2), claims of Her Majesty in right of Canada or a province for amounts that could be subject to a demand under subsection 224(1.2) of the Income Tax Act or under any substantially similar provision of provincial legislation.
(2.2) Where there is no quorum of secured creditors in respect of a particular class of secured claims, the secured creditors having claims of that class shall be deemed to have voted for the refusal of the proposal.
(3) A creditor who is related to the debtor may vote against but not for the acceptance of the proposal.
(4) The trustee, as a creditor, may not vote on the proposal.

131 Supra notes 50-51 and accompanying text.
The second anomaly is the BIA's threshold for acceptance of the proposal. Recall that the CCAA, requires a majority in number representing three-fourths in value of the voting creditors to accept the plan. Like the Code, the BIA requires only a majority in number representing two-thirds of the creditors to accept the plan. Theoretically, this places the debtor at an advantage, but the opting-out right of secured creditors may outweigh any such advantage.

It is also interesting to note that the apathy of secured creditors in not attending the meeting and voting creates a presumption of refusal of the proposal. The BIA does not make a similar presumption in respect of unsecured creditors, which leads one to conclude that there may be a presumption of acceptance, based on the rationale of Edwards, quoted above.

Subsection 1126(e) of the Code allows the court, after notice and hearing, to designate an entity whose vote was not cast in good faith or whose acceptance or rejection was not solicited in good faith. Once so designated, the court will disregard the votes of that entity for the purposes of determining acceptance or rejection of the plan. The House Report cites the example of a creditor with a conflict of interest in the proceedings. This example has formed the basis for the rejection of a creditor's vote whose motive was at cross-purposes with its status as a creditor, such as where the creditor's primary motive was to see the debtor's business fail so that the creditor's business would

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132 BIA s. 54(3).

133 Edwards, supra note 126. The BIA appears to address the potential problem of there being a lack of a quorum of secured creditors and those in attendance voting to accept the plan. The BIA does not provide for a quorum of creditors at a meeting to consider a proposal. However, the procedural provisions governing meetings of creditors generally would apply [BIA ss. 105 to 115]. Subsection 106(1) of the BIA provides that one creditor entitled to vote, or its representative, constitutes a quorum for a meeting of creditors. Thus, if the sole secured creditor attending the meeting or voting by proxy votes in favour of the proposal, that vote rules the rest of the class. BIA s. 62(2)(b) provides that secured creditors to whom a proposal is made will be considered to have accepted the proposal if a majority in number representing two-thirds in value of the secured creditors actually voting resolve to accept the plan.

134 Supra note 115 and accompanying text.

135 Code ss. 1126(c) and (d).

Another approach taken by the courts in determining whether there is bad faith, is to attempt to determine whether the creditor is seeking some type of preferential treatment vis-a-vis other creditors within the class in question. The presence of such a motive is considered to indicate a lack of *bona fides* by the voting party. In attempting to determine the motives of the voting party, the court must exercise some caution to avoid disqualifying the votes of creditors with a legitimate reason for voting for or against the plan. This limitation on the court's discretion is cause for concern, as it requires the court to determine the primary motivation of the creditor in a case where there are several reasonable explanations for the creditor voting as it did.

An interesting issue that the American courts have considered, is that of the *bona fides* of a party that acquires a control position within a class or veto power with respect to the plan through the acquisition of claims of other creditors. *In re Allegheny International, Inc.* held that the creditor, in acquiring the claims of other creditors to control the reorganization process and exercise a veto power over the plan, did so for reasons other than to further its interests as a creditor. Accordingly, the court disregarded the votes of that creditor in tabulating the votes. The courts must be cautious in disregarding the votes of creditors simply because of the way that the creditor acquired the votes. Having acquired a significant position within the class gives the creditor a stronger position but, at the same time, the creditor possesses greater risk, as it now has a greater financial stake in the debtor. Thus, the court must ascertain the true motivation of the creditor to determine its *bona fides* or lack thereof.

The plan proponent must satisfy the court that those voting on a plan under the CCAA did so

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137 *In re P-R Holding Corporation*, 147 F.2d 895 at 897 (2d Cir. 1945); *In re MacLeod Co.*, 63 B.R. 654 (Bankr. S.D. Oh. 1986).

138 *Young v. Higbee Co.*, 324 U.S. 204 at 211-212 (1945).

139 Norton Bankruptcy Law & Practice s. 91:24, citing *In re Federal Support Co.*, 859 F.2d 17 (4th Cir. 1988).

in good faith. This is not an express requirement under the CCAA. Like the American cases, the courts will disregard the votes of a party receiving a preferential advantage vis-a-vis other members of its class. Any advantage given to one member of a class, to the exclusion of others, breaches the fundamental objective of equality and equity among the creditors.

Edwards suggested the adoption of the more general approach. He submitted that "if members of any class voted against the proposal because of interests other than those of the class, their votes could properly be disregarded." Edwards based this submission on the holding in British American Nickel Corporation Limited v. O'Brien, and in particular, the statement of Viscount Haldane where His Lordship said:

... their Lordships do not think that there is any real difficulty in combining the principle that while usually a holder of shares or debentures may vote as his interest directs, he is subject to the further principle that where his vote is conferred on him as a member of a class he must conform to the interest of the class itself when seeking to exercise the power conferred on him in his capacity of being a member. The second principle is a negative one, one which puts a restriction on the completeness of freedom under the first, without excluding such freedom wholly.

The courts in Canada have cited this proposition with approval. Accordingly, it appears that the courts in Canada have taken the approach of the American courts by disregarding the votes of creditors who have some ulterior motive that may not coincide with those of other members of the class in which they are placed. Certainly, there is some merit in this approach, given the collective nature of a reorganization proceeding. However, there is also an inherent danger, given that the court must attempt to ascertain the primary intention of the creditor from the surrounding circumstances. It

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142 Edwards, supra note 126.
143 Ibid. at 613.
145 Ibid. at 373-374.
146 See e.g., Re Northland Properties Limited, supra note 33 at 185 (B.C.S.C.).
may be in order to consider more strongly the *caveat* of Viscount Haldane at the end of the above quotation. The courts must not unduly fetter the franchise given creditors in choosing whether or not to adopt a plan. After all, it may be unreasonable to expect a creditor to totally disregard its self-interest and act for the collective good. The court must start from the position that the creditor has total freedom to vote as it pleases, regardless of its motives in so voting. It is only when the actions of the creditor actually harm other creditors or the public interest that the courts must attempt to weigh the collective action against the interests of the creditor in question.\(^{147}\) This approach has the advantage of allowing the plan proponent to draft the initial plan on the footing that all creditors will act in total self-interest and, therefore, requires the debtor to present a reasonable plan, bearing in mind the interests of the creditors. The voting procedure and the "special majorities" balance, to a certain extent, the effects of this self-interest. The court however, is the final arbiter of whether a plan is fair and reasonable.\(^{148}\) To suggest that a creditor, when acting in its own interest, is lacking *bona fides* is perhaps unduly harsh and improper. The representatives of a creditor have a fiduciary duty to ensure that the creditor derives the most advantage from the reorganization proceeding. It would be an unfortunate situation if, in fulfilling that duty, those representatives are held to be acting in bad faith *vis-a-vis* other members of the class. It is the court that ultimately decides whether the plan is fair and reasonable, and in so doing, it must consider the interests of accepting and rejecting creditors.

This is not to deny that a creditor could be acting in bad faith. One may envision a situation where the plan proponent promises a creditor a secret advantage. Whether one chooses to refer to this type of arrangement a fraud on the other creditors or as evidence of bad faith of the debtor and the

\(^{147}\) This type of approach was alluded to by Thackray J. in *Re Quintette Coal Ltd.* (1991), 10 C.B.R. (3d) 197 at 222 (B.C.S.C.) where he said:

"I have commented earlier with respect to concerns as to the motivation of CdFI being self-serving. There is nothing evil about this. Indeed, it would be inappropriate for CdFI not to fight for its rights if it truly believes that to do so will give it a healthier complexion. However, I must consider the rights of many others, and the public interest bears heavily upon my thinking."

\(^{148}\) *Re Northland Properties Limited*, supra note 33 at 201 (B.C.C.A.).
creditor in question, the courts have disregarded the votes of the creditor in those circumstances.149

The decisions under the former Canadian Act took an approach similar to that under the CCAA. If
the debtor and certain creditors reached a secret arrangement which gave those creditors an advantage
to secure the votes of those creditors, the court would hold the proposal to be illegal and
unenforceable.150 The basis of these decisions is that such arrangements result in there being a
violation of the fundamental principle of equality that must exist among the creditors.151

2. Classification of Claims and Interests

Classification of claims and interests "is simply a method of recognizing difference in rights of
creditors which calls for difference in treatment."152 Simple though this statement may seem, the issue
of classification is vital to any reorganization regime and results in a significant amount of litigation.

There are two aspects of reorganization proceedings that make the issue of classification
particularly contentious. Given the "special" voting majorities necessary to accept a plan under each
of the statutory schemes, classification may determine the plan's fate. Multiple classifications may

149 Hochberger v. Rittenberg, supra note 141 where Fitzpatrick C.J.C. said

"Here there was a previous secret understanding that the appellants should receive security for
their debt and a direct advantage over all the others who were contracting on the assumption
that all were being treated alike. The notes sued on were given in pursuance of an agreement,
which was void, as made in fraud of the other creditors. . ." [at 452].

Duff J. appeared to take the less harsh approach of holding that the scheme merely lacked bona fides. He said:

"Any advantage, therefore, obtained by them as the price of their participation, which was not
made known to the other parties, must be an advantage which they could not retain without
departing from the line of conduct marked out in such circumstances by the dictates of good
faith." [at 455].

89 (Que. S.C.).


152 In re Rocky Mountain Fuel Co., 152 F.2d 747 at 750 (10th Cir. 1945) [hereinafter Rocky
Mountain].
provide a particular creditor with a disproportionate amount of power in a particular class, to the point of allowing that creditor to exercise a veto over the plan. On the other hand, a debtor who is in a position to justify the creation of few classes may nullify the untoward effects of a disgruntled creditor by diluting the creditor's vote with those of others that are satisfied with the results that the debtor is seeking.

The other aspect of the classification issue making it a particularly fruitful battleground is that it will ultimately determine the distributive aspects of the proceeding. Under all of the statutory schemes, the plan must treat members within each class equally, though there may be discrimination between classes. This issue is particularly acute in situations where the claim of a particular creditor may fall within two or more classes.

Classification has some practical importance in determining whether the plan has satisfied the preconfirmation requirements. Subsection 1129(a)(10) of the Code requires at least one class of impaired claims to accept the plan,\(^{153}\) whether the plan is to be confirmed under subsection 1129(a) or under the cram down provisions. Thus, it is important for the plan to include a class of impaired claims that will vote favourably.\(^{154}\)

Under the CCAA, each class of claims must accept the plan before it will be presented to the court for sanction.\(^{155}\) Because the CCAA does not contain any provisions allowing for the cram down of a plan on dissenting classes of creditors, it is imperative that the debtor attempt to dilute the voting rights of potential dissidents to attain the requisite majorities.

Similarly, the insolvent person, under the BIA, must classify the unsecured creditors to ensure acceptance by the requisite majorities. There may be an advantage to the insolvent person proceeding under the BIA, as the BIA contains a presumption that all unsecured creditors should be placed in one

\(^{153}\) Code s. 1124 which is reproduced, supra note 117.


\(^{155}\) CCAA s. 6.
class.\textsuperscript{156} To bind secured creditors to the proposal, the insolvent person must include them in the proposal and classify them in a manner that will attain acceptance by the requisite majorities.\textsuperscript{157}

Cases considering the issue of classification discuss the tests that establish a proper classification of claims or interests. Some speak of classifying claims according to the "nature" of the claim;\textsuperscript{158} others speak of the commonality of interests of the claimants in the debtor.\textsuperscript{159} However, one must not ignore the underlying reason for attempting to arrive at a proper classification scheme in a reorganization case. If the creditors unanimously agree to accept or reject the plan, the issue of classification will not be relevant. However, even one dissenting claim or interest holder raises a question concerning the propriety of the classification of that claim or interest holder. In other words, because the hallmark of the voting structure is a special majority rule, the courts must protect the rights of the dissenters and the question becomes one of whether the rights of the minority take precedence over the rehabilitation rights of the debtor. Unlike the elaborate corporate law regimes that protect the rights of the minority,\textsuperscript{160} neither the BIA, the Code nor the CCAA provides the dissenting minority with special rights or protection.

\textsuperscript{156} BIA s. 54(2)(b)(i) provides that, in voting on a proposed plan, the creditors are to vote by class and for that purpose, "all unsecured claims constitute one class, unless the proposal provides for more than one class of unsecured claim."

\textsuperscript{157} BIA s. 54(2)(a)(ii) allows "secured creditors in respect of whose secured claims the proposal was made" to vote on the plan and paragraph 62(2)(b) makes a proposal that is accepted by the creditors and approved by the court binding on, \textit{inter alia}:

"the secured claims in respect of which the proposal was made and that were in classes in which the secured creditors voted for the acceptance of the proposal by a majority in number and two thirds in value of the secured creditors present, personally or by proxy, at the meeting and voting on the resolution to accept the proposal."

\textsuperscript{158} \textit{In re Los Angeles Land \& Investments, Ltd.}, 282 F. Supp. 448 at 453 (D. Haw. 1968) [hereinafter \textit{L.A. Land}], aff'd 447 F.2d 1366 (9th Cir. 1971); \textit{Re Northland Properties Limited}, supra note 33 at 191 (B.C.S.C.).

\textsuperscript{159} \textit{Sovereign Life Assurance Co. v. Dodd}, [1892] 2 Q.B. 573 at 583 (C.A.).

One commentator stated that "[t]he function of classification . . . is one to which few immutable principles can be pronounced."\textsuperscript{161} This comment, along with the considerable body of case law considering classification issues in both Canada and the United States, suggests that the courts have moulded the principles to fit the circumstances of the particular case. The malleability of the concepts used in classifying claims allows the courts to approve or reject the debtor's classification, depending on whether the court views the reorganization of the debtor as desirable. In other words, the court has the power to give the debtor new life or condemn it to death on the classification issue alone. Therefore, classification should hold more than a passing interest for all parties, and debtors seeking to reorganize their affairs should dedicate significant time to the task of classifying and formulating a means of justifying the classification.

This section will provide an overview of the legislative schemes governing classification and will briefly examine the legislative histories. Following the overview, we will examine the case law to determine whether the courts have established principles or tests that a plan proponent may use in classifying claims. Finally, this section will consider the issue of whether the courts should maintain a broad discretion concerning the classification issue or whether a less flexible approach would be preferable.

The first four subsections of section 1123 illustrate the importance of the classification issue under the Code. The section outlines the required elements of a plan. Those subsections provide that a plan must designate classes of claims and interests, specify which classes are unimpaired and the treatment of any impaired class and treat of each member within a class the same, unless the member agrees to less favourable treatment. The only section in the Code that gives any guidance concerning

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\textsuperscript{161} C.F. Vihon, "Classification of Unsecured Claims: Squaring the Circle" (1981) 55 Am. Bankr. L.J. 143 at 145. See also, J.C. Anderson, "Classification of Claims and Interests in Reorganization Cases Under the New Bankruptcy Code" (1984) 58 Am. Bankr. L.J. 99 at 100 where the author noted that "[u]nfortunately, classification concepts were not very clear or consistently applied in reorganization cases under the old Act; the new Code does not remedy this problem."
the composition of a class is section 1122 which provides:

(a) Except as provided in subsection (b) of this section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.

(b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.

Subsection (b) is the "de minimus" exception to classification. Usually, the plan provides for full payment of the de minimus claims to avoid the necessity of having to pay several small dividends and prevent a claimant with a very small stake in the reorganization from raising issues that may delay or hinder the debtor's reorganization efforts. The legislative history noted that, before its codification as subsection (b), the practice of paying small claims in full was common in reorganizations.

Subsection (a) requires only that the claims or interests placed in a particular class be "substantially similar." It does not, however, require that all similar claims or interests be placed in the same class. As the plan usually classifies secured claimants separately, given the unique nature or priority of their claims, this issue usually arises only with respect to unsecured claimants. Should the claims or interests in a particular class not be substantially similar, the court must deny confirmation of the plan, as it does not comply with the Code. Subsection 1122(a) is in keeping with the voting policy referred to earlier, where the minority should be bound only by the decisions of claim or interest holders having similar interests or stakes in the debtor.

The CCAA is not so specific as the Code with respect to the requirement of the plan.

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163 Senate Report at 118 n. 26, citing Brockett v. Winkle Terra Cotta Co., 81 F.2d 949 at 952 (8th Cir. 1936); In re New Rochelle Coal & Lumber Co., 77 F.2d 88 at 882-883 (2d Cir. 1935); In re Realty Associates Securities Corporation, 53 F. Supp. 1010 at 1011 (E.D.N.Y. 1943).

164 See supra notes 192-207 and accompanying text, where this issue is examined more fully.

165 Code s. 1129(a)(1).

166 Supra notes 158-160 and accompanying text.
proponent to classify creditors, although it clearly exhibits an intention that the debtor may classify claims. For example, sections 4 and 5 refer to the debtor proposing a compromise or arrangement with its unsecured and secured creditors "or any class of them." Similarly, the voting section\(^{167}\) refers to the special majorities of the creditors "or class of creditors." The CCAA, however, contains no provision to guide the debtor in establishing classes of creditors.

The BIA also envisages the classification of creditors although, like the CCAA, it does not make classification mandatory. Subsection 50(1.2) provides:

A proposal must be made to creditors generally, either as a mass or separated into classes as provided in the proposal, and may also be made to secured creditors in respect of any class or classes of secured claim, subject to subsection (1.3). \([\text{emphasis added}]\)

Subsection 50(1.3) then provides that if the secured creditors are placed into separate classes, the insolvent person must make the proposal to all of the secured creditors in that class. Unlike the Code and the CCAA, the BIA sets forth certain criteria that govern whether certain secured creditors fall within a particular class and gives the court the power to determine the propriety of any classification scheme set forth in the proposal.\(^{168}\)

More than any other issue discussed in this paper, the history has influenced the issue of classification under the Code. In fact, the House Report and the Senate Report said of section 1122:

This section codifies current case law surrounding the classification of claims and equity securities. It requires classification based on the nature of the claims or interests classified, and permits inclusion of claims or interests in a particular class only if the claim or interest being included is substantially similar to the other claims or interests of the class.\(^{169}\)

It would therefore be useful to examine the evolution of the legislation and the way in which the courts have interpreted its terms.

Section 77B provided that the court could "determine ... for the purposes of the plan and its acceptance, the division of creditors ... into classes according to the nature of their respective

\(^{157}\) CCAA s. 6.

\(^{158}\) BIA ss. 50(1.4) and (1.5).

\(^{159}\) House Report at 406; Senate Report at 118.
claims." First, we must note that it was the court, not the debtor, that determined the classification of creditors. The second aspect of this section which bears attention is that classes were to be divided according to the "nature" of the claim. The leading case of In re Palisades-on-the-Desplains 170 construed this provision broadly. The court did not follow its legislative mandate that required it to look at the nature of the claims but instead, focused on the broader policy issues involved in a reorganization case. It rejected the notion that creditors of equal rank with claims against the same property should always be placed in the same class or that creditors with claims against different properties should always be placed in different classes. Rather, the court focused on whether the creditor was harmed by the classification and whether the classification fostered the confirmation of a plan that was in the best interests of the creditors. 171 In other words, if the creditors would receive more under the reorganization than in a liquidation, the court would uphold the classification whether or not the nature of the claims in the class were similar.

Section 77B was repealed in 1938 by the Chandler Act, which divided the reorganization sections into three chapters, being Chapters X, XI and XII. 172 The provisions of each chapter

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170 Supra note 111.

171 Ibid. A contrary approach was taken in St. Louis Union Trust v. Champion Shoe Machinery Co., 109 F.2d 313 (8th Cir. 1940), where the court held that, despite the fact that the classification fosters the policy goals of a reorganization proceeding, a classification will not be upheld if it derogates from the rights of a senior creditor to its agreed upon priority position. Such a classification would not be fair and equitable. However, in these early cases, this case appears to be an anomaly as the courts generally favoured the approach taken in the Palisades-on-the-Desplains case. See e.g., Continental Insurance Co. v. Louisiana Oil Refining Corp., 89 F.2d 333 (5th Cir. 1937); In re Ogden Apartment Bldg. Corporation, 90 F.2d 712 (7th Cir. 1937); In re Sixty-Seven Wall Street Restaurant Corp., 23 F. Supp 672 (S.D.N.Y. 1938).

172 For our purposes, the provisions of Chapter X and Chapter XI are the most relevant as they were intended to deal, respectively, with reorganizations of publicly-held corporations and closely-held corporations, where the debtor was seeking to reorganize its affairs with its unsecured creditors. Chapter XII was a specialized chapter dealing with arrangements involving real property by persons other than corporations.
concerning classification were similar to the others and to section 77B. There are certain fundamental differences between the provisions of the Chandler Act and those of the Code. Under the Chandler Act, the court classified claimants. Under the Code, the debtor classifies the claim and interest holders and the court's only role in the classification procedure is to confirm the plan, once the plan proponent satisfies it that the plan complies with the applicable provisions of the Code, including section 1122, or refuse to confirm the plan.

In addition, some case law under the Chandler Act held that there was a presumption that all creditors of equal rank should be placed in the same class. Others held that this was not an absolute requirement and if there was equitable reason for a separate classification of claimants of equal rank, the court would permit it. The Code appears to have resolved this debate, as the only requirement is that the claims or interests within a class must be "substantially similar" to each other. There is no a requirement that all such claims be placed in the same class. Thus, one must review the cases decided under the Chandler Act with some caution.

The trend that started under the section 77B cases continued in the early Chandler Act cases.

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173 Vihon, supra note 161 at 155. Chandler Act ss. 197 and 351 provided as follows:

"197. For the purposes of a plan and its acceptance, the judge shall fix the division of creditors and stockholders into classes according to the nature of their claims or stock interests. For such classification, and if necessary, the judge shall, upon the application of the trustee, the debtor, any creditor or any indenture trustee, fix a hearing on notice to the holders of the secured claims, the trustee, the debtor and such other persons as the judge may designate, to determine summarily the value of the security and classify as unsecured the amount in excess of such value.

351. For the purposes of the arrangement and its acceptance, the court may fix the division of creditors into classes and, in case of controversy, shall, after hearing and upon notice, summarily determine the controversy."

174 Code s. 1129(a)(1).

175 Rocky Mountain, supra note 152 at 751; In re L.A. Land, supra note 158 at 453.


177 See e.g., Dudley v. Mealey, 147 F.2d 268 at 271 (2d Cir. 1945), cert. denied, 325 U.S. 873 (1945); In re Sixty-Seven Wall Street Restaurant Corporation, supra note 171.

178 Code s. 1122(a).
The courts were not concerned with the legislative mandate of classifying claims and interests according to their similarity in nature. They focused, instead, on the broader policy of encouraging the rehabilitation efforts of the debtor.\textsuperscript{179} This policy was especially important if there was minimal harm imposed on creditors.\textsuperscript{180} One author suggested that these decisions were based on an "economic realism" rather than on an exercise in statutory interpretation and that the courts were merely attempting to enforce the underlying policies of the reorganization system.\textsuperscript{181} The court in \textit{Winston Mills} suggested a further rationale for this approach by holding that the reorganization process had built-in checks and balances,\textsuperscript{182} in that the negotiations between the debtor and its creditors and the necessity of acceptance of the plan by the requisite statutory majorities would control abuses in the classification process. This rationale, with respect, ignores the economic reality that often, in reorganization cases, there is a disparity between the bargaining positions of the parties and one party may exact an advantage by merely threatening to withhold its consent to the plan.

The court took a more stringent approach in \textit{In re Hudson-Ross, Inc.}\textsuperscript{183} In that case, the parties had reached an agreement before the commencement of the reorganization that set forth the substance of the plan, including the classification of claims. Notwithstanding the agreement, the court refused to confirm the plan, on the basis that the classification was discriminatory and arbitrary. The court held that, to sanction the plan, the plan proponent must satisfy it that the classification was

\textsuperscript{179} \textit{Western Mesa Oil Corp. v. Edlou Co.}, 143 F.2d 843 (9th Cir. 1944), which was a case under Chapter XI. Examples of other Chapter XI cases adopting a similar approach are \textit{Bartle v. Markson Bros. Inc.}, 314 F.2d 303 (2d Cir. 1963) and \textit{In re Winston Mills, Inc.}, 1 C.B.C. (2d) 121 (Bankr. S.D.N.Y. 1979). The latter case is interesting in that the court refused to intervene in the classification which were the result of "debtor-creditor dialogues." [at 127] In other words, it appears that the court assumed that there must have been some reasonable basis for the creditors agreeing to diverse treatment and, on that basis, chose not to question the wisdom of the parties in interest.

\textsuperscript{180} \textit{In re Realty Associates Securities Corporation}, 53 F. Supp 1010 (E.D.N.Y. 1943), which was a Chapter X case. See also \textit{Rocky Mountain}, supra note 152.

\textsuperscript{181} Vihon, supra note 161 at 158.

\textsuperscript{182} \textit{In re Winston Mills, Inc.}, supra note 179.

\textsuperscript{183} \textit{In re Hudson-Ross, Inc.}, 175 F. Supp 111 (N.D. Ill. 1959).
necessary and proper, had a reasonable basis and was in the best interests of creditors.\textsuperscript{184}

Had the foregoing cases been the only authorities on which Congress relied in establishing that section 1122 "codifies current case law surrounding the classification of claims," one would wonder exactly what the current case law was, especially given the vague language of section 1122. The courts appeared to ignore the requirement that claims and interests were to be classified according to their "nature."\textsuperscript{185} However, in reviewing the cases, one may find certain very basic, albeit vaguely framed, principles and surmise that it is these basic principles of classification to which Congress alluded. These basic principles are as follows:

1. creditors and shareholders, because of their different interests in the debtor and its assets should be separately classified;\textsuperscript{186}

2. shares with different attributes, such as preferred and common shares, should be placed in separate classes;\textsuperscript{187}

3. secured claims of the same or different rank against different collateral or of different rank against the same collateral should be separately classified;\textsuperscript{188} and

4. if claimants are placed in the same class but the plan proposes to treat individual members of the class differently, separate classification is necessary.\textsuperscript{189}

One may attempt to generalize the foregoing rules by saying that the plan should separately classify

\textsuperscript{184} \textit{Ibid.} at 112.

\textsuperscript{185} See Chandler Act ss. 197 and 351, \textit{supra} notes 170-182.

\textsuperscript{186} \textit{In re Phoenix Hotel Co. of Lexington, Ky.}, 83 F.2d 724 at 726-727 (6th Cir. 1936), cert. denied sub nom. Security Trust Co., Trustee \textit{v.} Baker, 299 U.S. 568 (1936).


\textsuperscript{188} \textit{Kyser v. MacAdam}, 117 F.2d 232 at 237 (2d Cir. 1941); \textit{Mokava Corp. v. Dolan}, 147 F.2d 340 at 344 (2d Cir. 1941); \textit{cf. In re Palisades-on-the-Desplaines supra} note 111 at 217-218.

\textsuperscript{189} \textit{In re Boston Metropolitan Buildings, Inc.}, 92 F. Supp. 843 at 848 (D. Mass. 1950); \textit{cf. Rocky Mountain, supra} note 152 at 750-751.
claimants or interest holders if they have different rights\textsuperscript{190} or if the nature of their respective claims differs.\textsuperscript{191} Although these propositions appear to beg the issue of classification, they point to a recognition by the courts that requires them to look to something more than the policy considerations governing a business reorganization. Although the bankruptcy courts are courts of equity, they cannot ignore the legislative mandate bestowed upon them.

Armed with these general principles established under the current case law, we may undertake an examination of the Code to determine whether the courts have followed the Congressional directive. Like the cases under the Chandler Act, the cases under the Code do not allow for the extraction of any consistent and universally-applied principles, other than perhaps the general principles outlined above. The most fruitful area of concern is whether the plan proponent may put unsecured creditors into separate classes. Some courts allow the plan proponent to classify separately unsecured claims,

\textsuperscript{190} Rocky Mountain, supra note 152 at 750.

\textsuperscript{191} L.A. Land, supra note 158 at 453-454, described the concept of the "nature" of the claim as follows:

"The test to be applied appears to be one directed toward a determination of the 'nature' of the claim. This would encompass an analysis of the legal character or quality of the claim as it relates to the assets of the debtor. Basically, it is simply a method of recognizing the rights of creditors which call for difference in treatment. . . .

The courts recognize that the word 'nature' is used in no technical sense in law but is used in its ordinary common vernacular, wherein it means kind, sort, species or character. Where the differences are in the rates of interest, in the amounts, in the dates of maturity, in the names of payees, the manner in which the claim arose and such other minor details, they cannot affect the 'nature,' i.e., the kind of claim, otherwise a separate class would have to be provided for nearly every type of situation which would be an unthinkable calamity when the object and aim of the statute is regarded." [citations omitted]

The court then went on to provide an example of the foregoing proposition, quoting Collier on Bankruptcy, Vol. 6A, Section 9.13(1), as follows:

The fact that [unsecured] claims may take various forms - as for example, notes, accounts, written contracts, torts and the like - would not ordinarily compel separate classification since an unsecured indebtedness or liability is the common denominator of all."
provided there is a reasonable basis for the separate classification and that the debtor is not abusing the reorganization process through the classification procedure. Other courts hold that there is a presumption that similar claims should be placed in the same class and they would only allow separation of similar claims if there is a valid business reason for so doing. Both tests however, prohibit classifications that are arbitrary or unreasonable.

There is a danger in adopting either of the tests without qualification. Pine Lake illustrates this concern. In that case, the court held that the plan could classify an unsecured deficiency claim of a secured creditor with other unsecured claims, notwithstanding that the deficiency claimant agreed to subordinate its claim to those of the general creditors. The court arrived at its conclusion by focusing on the "type" of claim rather than the "nature" of the claim. The court, in L.A. Land, set forth the following test:

The test to be applied appears to be one directed toward a determination of the 'nature' of the claim. This would encompass an analysis of the legal character or the quality of the claim as it relates to the assets of the debtor. If the court in Pine Lake applied this test, the plan should have classified the claims separately.

Although both sets of claimants in Pine Lake would be considered unsecured creditors, the "legal character" of each of their claims was different, which may have caused them to view the proposed plan differently. For example, assuming that the secured creditor's deficiency claim made up 85% of

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192 In re Jersey City Medical Center, 817 F.2d 1055 at 1061 (3d Cir. 1987); In re U.S. Truck Co., Inc., 800 F.2d 581 at 586 (6th Cir. 1986).

193 In re A.G. Consultants Grain Division, Inc., supra note 176.


195 In re Holywell Corp., 913 F.2d 873 at 880 (11th Cir. 1990).

196 Pine Lake, supra note 194.

197 Supra note 158 at 453.

198 Ibid.
the total unsecured claims, the deficiency claimant would support a proposed plan that would pay all unsecured creditors a pro rata share of a certain sum. However, the balance of the unsecured creditors would reject the plan on the basis that, if the court enforced the subordination agreement, they would receive payment on their claims before any payment to the deficiency claimant. However, the class would accept the proposed plan, as the deficiency claimant holds the balance of power.

Conversely, a rule permitting the plan proponent to create a multiplicity of classes could also result in abuse, such as through the gerrymandering of votes.199 The courts could use the good faith requirement in paragraph 1129(a)(3) of the Code to control the gerrymandering of votes through the classification procedure.200

Thus, the courts must return to the vague standard that requires an examination of the "nature" of the particular unsecured claim in issue. In many cases, the parties themselves, through the process of negotiation, will establish the classification of claims and interests. This would render an examination of the issue by the court unnecessary. However, if a creditor objects to the classification, the court must conduct a thorough examination of the nature of the claims or interests in the impugned class.

Generally, the principles established under the Chandler Act concerning secured claimants apply under the Code.201 In other words, secured claims are classified according to whether they are

199 In re Mastercraft Record Plating, Inc., 32 B.R. 106 at 108 (Bankr. S.D.N.Y. 1983), rev'd on other grounds, 39 B.R. 654 (S.D.N.Y. 1984), where the court stated that "[c]lassification cannot be used to divide like claims into multiple classes in order to create a consenting class so as to permit confirmation." A stronger statement of this policy was made in Re S. & W Enterprise, 11 B.C.D. (C.R.R.) 630 at 634 (Bankr. N.D. Ill. 1984), where the court stated that "[T]he manipulation of unsecured claims . . . for the sole purpose of complying with the voting requirement of section 1129(a)(10) shall not be tolerated."

200 W. Blair, "Classification of Unsecured Claims in Chapter 11 Reorganization" (1984) 58 Am. Bankr. L.J. 197 at 225. See e.g., Greystone, supra note 194, where the court said:

"[T]here is] one clear rule that emerges from otherwise muddled caselaw under s. 1122 claims classification: thou shall not classify similar claims differently in order to gerrymander an affirmative vote in a reorganization plan." [at 139].

201 Supra notes 186-191.
of the same rank and whether they have security in the same or different collateral. The courts hold, as a general proposition, that the plan should classify secured claims separately, unless there are other secured creditors that have the same priority ranking and the same rights to the collateral. Although this may create hardship on the debtor by giving each secured creditor a veto over the plan, the secured creditors have differing interests in the assets of the debtor depending on the nature of the collateral and their priority to it. Furthermore, the rights of each secured creditor will differ, depending on the contents of the security agreement.

The commentators generally agree that a flexible approach to the classification issue which permits the debtor to separate substantially similar claims into separate classes is favourable. The primary advantage in allowing flexibility is that the plan proponent may adjust the classes to ensure that it meets the prerequisites to confirmation of the plan. It also puts minimal constraints on the courts that must consider diverse factual situations. This approach also appears to fit within the Congressional mandate that "[t]he parties are left to their own to negotiate a fair settlement." Allowing the parties to reach compromises with respect to individual claims meets this objective. The plan proponent is then free to place the claim or interest holder in the appropriate class. A restrictive classification regime requiring all substantially similar claimants, such as unsecured creditors, to be placed in the same class may inhibit bargaining among the parties because of the difference in the economic needs and interests of the claimants. In other words, classification rules that provide less flexibility deprive the parties of the necessary flexibility to fashion a solution. One author expressed the rationale for the necessity of flexibility as follows:

Finally, there is significant support for broad discretion in the classification of creditors under the Bankruptcy Code, such as the requisite for flexibility and the avoidance of one creditor

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203 See e.g., Robin, supra note 154; Blair, supra note 200; Anderson, supra note 161.

204 House Report at 224.

205 Blair, supra note 200 at 224.
holding a veto power over the proposed plan. When the preceding concerns are addressed by permitting broad discretion in the classification of creditors, the Bankruptcy Code's promotion of reorganization is reinforced.206

This rationale suggests that reorganization is the primary objective of such a proceeding, ignoring the goal of treating creditors with similar claims equally. However, an unwavering policy of flexibility appears to encourage abuse. One wonders why the rule concerning acceptance of the plan by an impaired class even exists, if the plan proponent can merely structure the classes to attain that acceptance. One might take the position that protection of the creditors' interests is more important than the reorganization itself. Treating substantially similar claims differently is contrary to one of the normative bases of a reorganization regime. Courts that take the position that classification to secure appropriate votes may be an abuse of the bankruptcy process address this concern of equality of creditors.

Since the enactment of section 77B, the policymakers have continually stressed that classification should be based on the nature of the claim. This fits within the policy that the majority can dictate the decision of the class only if all members of the class have a similar interests in the assets of the debtor. To deviate from this policy in the interests of attaining acceptance of the plan does not fit within the legislative mandate. Certainly, the courts generally follow the broad principles outlined earlier207 and quite properly allow the plan proponent flexibility within those principles. However, to allow the plan proponent to completely ignore those fundamental principles gives judicial sanction outside of the mandate accorded under the legislation.

The CCAA and the BIA take differing approaches to the classification issue. The CCAA takes an approach similar to that of the Code in that the plan proponent is provided with very little guidance

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206 Robin, supra note 154 at 224.

207 Supra notes 186-191 and accompanying text.
in establishing acceptable classifications of creditors.\footnote{Reference is made to the plan proponent being the person, in the first instance, to propose the classification of creditors. This is based on the case \textit{Re Hellenic Trust Ltd.}, [1975] 3 All E.R. 382 (S.C.), which held that the debtor has the primary responsibility of classification of creditors.}{208} The BIA provides some minimal guidance, which may prove to be a two-edged sword. On the one hand, the factors provided in the BIA may provide some guidance in how to structure the classes. On the other, the courts may hold that the factors are requirements, which will significantly reduce the flexibility exhibited under both the Code and the CCAA. This may have the untoward effect of reducing the ability to negotiate a plan for the benefit of all in a case where reorganization is the most attractive solution.

In looking at the CCAA, one is tempted to conclude that the classification of creditors is not subject to any rule\footnote{The CCAA does not require the classification of creditors in the plan. Throughout the legislation, reference is made to creditors "or any class of them" which suggests that creditors may be classified. Needless to say, the CCAA provides no guidance as to how this classification is to be determined.}{209} and that the courts are free to establish classes on whatever basis they choose. However, the CCAA was based largely on the English \textit{Joint Stock Companies Arrangement Act (1870)},\footnote{33 & 34 Vict. c. 104.}{210} under which a rich body of case law had developed. In addition, the legislative history may provide some guidance concerning the intention of the policymakers in using the term "classes of creditors." In discussing what are now sections 6 and 7 of the CCAA, the Honourable C.H. Cahan, who was the Member of Parliament sponsoring the passage of the bill that became the CCAA, said "[e]ach class of creditors who have the same interest may decide . . . with respect to any proposed compromise . . ."\footnote{House of Commons Debates (9 May 1933) at 4723 [emphasis added].}{211} This is in keeping with the policy that the decision of the majority may bind a dissenting minority, only if the interests of all of the class members are the same or substantially similar. Otherwise, the plan and the courts would be "sacrificing the rights of the minority."\footnote{Edwards, supra note 126 at 603.}{212}
Edwards,²¹³ proposed the use of the "identity of interests" test for classification, based on the legislative history. Although the courts overwhelmingly reject this test on the basis of their interpretation that it requires the placement of creditors in one class only if they have identical interests,²¹⁴ it is submitted that neither the legislative history nor Edwards contemplated such a narrow scope for that test. The test did not contemplate that the interests had to be identical but merely that they be, in American parlance, "substantially similar" such that all claimants within the class have similar interests in either rejecting or accepting the plan.

Classification according to the "interests" of the creditors may be based on the statement of Lord Esher M.R. in Sovereign Life Assurance Co. v. Dodd²¹⁵ where His Lordship said:

The Act says that the persons to be summoned to the meeting (all of whom, be it said in passing, are creditors) are persons who can be divided into different classes - classes which the Act of Parliament recognises, though it does not define them. This, therefore, must be done: they must be divided into different classes. What is the reason for such a course? It is because the creditors composing the different classes have different interests; and, therefore, if we find a different state of facts existing among different creditors, which may differently affect their minds and their judgments, they must be divided into different classes.²¹⁶

In the same case, Bowen L.J. said:

It seems plain that we must give such a meaning to the term "class" as will prevent the section being so worked as to result in confiscation and injustice, and that it must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest.²¹⁷

An Ontario court applied this rationale in Re Wellington Building Corp. Ltd.,²¹⁸ where the court held that secured creditors with different priorities on the same property should be placed in

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²¹³ Edwards, supra note 126 at 602-603.


²¹⁶ Ibid at 579 [Emphasis added].

²¹⁷ Ibid. at 583 [emphasis added].

different classes. To hold otherwise would allow subordinate creditors to destroy the priority, rights and security of the secured creditors holding prior mortgages on the property.219

This approach, however, may foster a multiplicity of classes, which is disadvantageous to the plan proponent, as it may provide individual creditors with veto powers. The result may be fewer reorganizations. A compromise may be struck using the final words in the statement of Lord Bowen, quoted above, where he states that the plan may classify dissimilar claimants together, provided their interests coincide to such an extent as will allow them to consult together.220 The Alberta Court of Appeal applied this approach, now known as the "commonality of interest," in the reorganization proceedings involving the acquisition of the assets of Dome Petroleum Co. by Amoco Canada Petroleum Co.221 Although the commonality of interest test does not require or even encourage the plan proponent to place identical interests in the same class, neither does it even appear to follow the fundamental principles established under the Code.222

The commonality of interest test may also be a two-edged sword for the plan proponent. It allows the debtor to place diverse creditors in the same class based on the nature of the debt, the

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219 Ibid. at 55.

220 R.N. Robertson, "Legal Problems on Reorganization of Major Financial and Commercial Debtors" Canadian Bar Association - Ontario, Continuing Legal Education, 5 April 1983 at 20

221 In this case, the parties chose to use the arrangement provisions of the Canada Business Corporations Act, R.S.C. 1985, c. C-44. Although the fundamental premise of these provisions differs from the CCAA, the decisions appeared to analogize the substance and procedures of each. As a result, the decisions arising from these proceedings may have some precedential value in proceedings under the CCAA. See e.g., Savage v. Amoco Acquisition Co., (1988) 68 C.B.R. (N.S.) 154 (Alta. C.A.), leave to appeal to the S.C.C. refused 70 C.B.R. (N.S.) xxxii (note).


222 See discussion, supra notes 186-191 and accompanying text. For example, in Re Woodward's Ltd., supra note 214, Tysoe J. allowed terminated employees and trade creditors, which were acknowledged to be creditors with different legal rights, to be placed in the same class on the basis of their commonality of interest as unsecured creditors.
creditor, the security or on the remedies of the creditors.\textsuperscript{223} Alternatively, it may require the placement of diverse interests in separate classes, which may give a single creditor a veto over the plan.\textsuperscript{224} The result will depend on whether the court views reorganization\textsuperscript{225} or equality of creditors of equal rank as the primary purpose of the legislation.\textsuperscript{226}

The case involving Woodward's Ltd.\textsuperscript{227} took an interesting and somewhat novel approach to the classification issue. In that case Tysoe J., extended the application of the commonality of interest test by looking beyond the legal rights of the creditors seeking separate classification, to the effect of the proposed plan and the consequences of a liquidation on those creditors. He explained his approach as follows:

The case authorities focus on the differences in the legal rights of the creditors in determining whether their interests are sufficiently similar or dissimilar to warrant creditors being placed in the same class or separate classes. I agree that it is the legal rights of the creditors that must be considered and that other external matters that could influence the interests of a creditor are not to be taken in account. However, it is my view that the legal rights should not be


\textsuperscript{224} Re NsCDiesel Power Inc. (1990), 79 C.B.R. (N.S.) 1 (N.S.S.C.)

\textsuperscript{225} In Oakwood, supra note 109, Forsyth J. held that separate classification of secured creditors holding separate security over different assets or security having different relative values was unwarranted and said:

"First, it is clear that the C.C.A.A. grants a court the authority to alter the legal rights of parties other than the debtor company without their consent. Second, the primary purpose of the Act is to facilitate reorganizations and this factor must be given due consideration at every stage of the process, including the classification of creditors made under the proposed plan. To accept the 'identity of interest' proposition as a starting point in the classification of creditors necessarily results in a 'multiplicity of discrete classes' which would make any reorganization difficult, if not impossible, to achieve." [at 28, emphasis added].

\textsuperscript{226} See e.g., Nova Metal Products Inc. v. Cominskey (Trustee of) (1990), 1 C.B.R. (3d) 101 (Ont. C.A.), where the court held that secured creditors with discrete interests should be classified separately.

The Nova Scotia Court of Appeal rejected the notion that equality of treatment among creditors was a necessary or even a desirable goal in Re Keddy Motor Inns Ltd. (1992), 13 C.B.R. (3d) 245 at 255 (N.S.C.A.).

\textsuperscript{227} Re Woodward's Ltd., supra note 214.
considered in isolation and that they must be considered within the context of the provisions of the reorganization plan. It would be appropriate to segregate two sets of creditors with similar legal interests into separate classes if the plan treats them differently. Conversely, it may be appropriate to include two sets of creditors with different legal rights in the same class if the plan treats them in a fashion that gives them a commonality of interest despite their different legal rights. In addition, when the court is assessing whether there is a sufficient commonality of interest to include two sets of creditors in the same class, it is necessary in my view to examine their legal rights within the context of the potential failure of the reorganization plan. The treatment of the two sets of creditors under the plan should be compared to the rights they would have in the event of the failure of the plan (i.e., bankruptcy or other liquidation).

With respect, the object of classification is to ensure that the plan treats creditors of equal rank the same and that only creditors having the same interest in the debtor's assets shall determine the fate of the class within the plan. To allow diverse interests to affect each other's rights, simply because the plan treats them similarly may allow the plan proponent to manipulate the classes to further dilute the votes of dissident creditors. This approach gives the debtor an inordinate amount of power and puts the "cart before the horse." It is the preproceeding rights that should govern classification, not the rights as established under the plan.

Thus, the same problems and concerns that plague the classification issue under the Code arise in Canada. The courts take either a restrictive approach, resulting in a multiplicity of classes or a liberal approach, resulting in fewer classes, but classes containing creditors with diverse and potentially conflicting interests. The former approach appears to coincide with the legislative intent of the classification procedure while the latter provides the plan proponent with an opportunity to dilute the votes of a dissident creditor. This issue, more than any other examined in this paper, requires the policymakers to determine whether business reorganizations are preferable to the rights of creditors and interest holders. The policymakers can require the courts to adopt a liberal or restrictive approach and to provide flexibility, depending on the circumstances.

This paper has been generally critical of the BIA and its apparent lack of interest in fostering reorganization efforts of the insolvent person. A similar criticism is made of the way that the BIA

\[228\] Ibid. at 80-81.

\[229\] See e.g., chapter V(5).
deals with the classification issue. While the presumption that the debtor can classify all unsecured creditors together may allow the dilution of the interests of dissident creditors, the manner of classifying secured creditors leaves the insolvent person with little alternative but to create a multiplicity of classes. Subsection 50(1.4) of the BIA provides:

Secured claims may be included in the same class if the interests of the creditors holding those claims are sufficiently similar to give them a commonality of interest, taking into account:
(a) the nature of the debts giving rise to the claims;
(b) the nature and priority of the security in respect of the claims;
(c) the remedies available to the creditors in the absence of the proposal, and the extent to which the creditors would recover their claims by exercising those remedies;
(d) the treatment of the claims under the proposal, and the extent to which the claims would be paid under the proposal; and
(e) such further criteria, consistent with those set out in paragraphs (a) to (d), as are prescribed.

This subsection codifies the case law under the CCAA. However, it does not provide the added element of allowing the court to consider the policies underlying the reorganization process. This results in the insolvent person having little latitude in classifying secured claims and requiring the creation a multiplicity of classes, each with a potential veto. This gives secured creditors an inordinate amount of power in determining the fate of the debtor. If reorganizations are to be encouraged under the BIA policymakers must give the insolvent person more flexibility over the classification issue.

C. CRAM DOWN

Under the Code, if a class of creditors or interest holders rejects the proposed plan, the court may "cram" the plan down on the dissenting class, provided the plan meets certain requirements.

There is no concept of cram down in Anglo-Canadian law, although the policymakers and the judiciary are well aware of the concept. Neither the reported cases nor the commentaries on the

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230 See e.g., Colter Committee Report at 53.

231 See e.g., Olympia & York Developments Ltd. v. Royal Trust Co., supra note 2; Multidev Immobilia Inc. v. Société Anonyme Just Invest (1988), 70 C.B.R. (N.S.) 91 (Que. S.C.) These courts take a unique approach to the issue of a non-assenting class of creditors. In both cases, rather than refusing to sanction the plan, the courts "carved out" the portion of the plan that concerned the objecting creditor and sanctioned the balance of the plan. In Olympia & York Developments Ltd., the
Anglo-Canadian business reorganization regimes justify its rejection.

This section will examine the normative and historical bases of the cram down under the Code and the prerequisites that the plan must meet to invoke it. The object of this examination is to determine whether Canadian policymakers should reevaluate the concept with a view to incorporating some of its more desirable features into Canadian law or whether the present Canadian regime, which prescribes that rejection of the plan by even one class of creditors or interest holders results in a complete failure of the plan, is preferable.

Under Chapter 11, there are two ways that a plan proponent may attain confirmation of a plan. First, the plan proponent may obtain the unanimous consent of all impaired\textsuperscript{232} classes of claims and interest holders.\textsuperscript{233} Once the proponent obtains the consents, it may seek confirmation by the court under subsection 1129(a). The proponent may invoke the second method once it meets all requirements of subsection 1129(a), except that an impaired class rejects the plan. In such a case, the plan proponent may seek to have the plan crammed down under subsection 1129(b) over the "carved out" creditors maintained security over assets of the debtor and were therefore, allowed to realize on the security.

It may be arguable that, in appropriate circumstances, the concept of cram down may be invoked. In \textit{Re Alabama, New Orleans, Texas & Pacific Junction Railway Co.}, supra note 29, Bowen L.J. stated:

"Now, I have no doubt at all that it would be improper for the Court to allow an arrangement to be forced on \textit{any class of creditors}, if the arrangement cannot reasonably be supposed by sensible business people to be for the benefit of that class as such, otherwise the sanction of the Court would be a sanction to what would be a scheme of confiscation. The object of this section is not confiscation. \ldots Its object is to enable compromises to be made which are for the common benefit of the creditors as creditors, or for the common benefit of some class of creditors as such." [at 243, emphasis added].

On the basis of this statement, if one were in a position to argue that the plan was, according to sensible business people, for the benefit of the class of dissenting creditors, one may be in a position to cram the plan down on the class in question. This issue has not been raised in any of the reported cases to date.

\textsuperscript{232} The definition of impairment is set forth supra note 117.

\textsuperscript{233} Recall that unimpaired classes are conclusively presumed to have accepted the plan under subsection 1126(f) of the Code.
objections of the dissenting class provided that, *inter alia*:

1. the plan does not discriminate unfairly;\(^{234}\)

2. the plan is fair and equitable;\(^{235}\) and

3. the provisions of 1129(a) are met including the fact that each impaired class will receive as much under the plan as it would if the debtor were liquidated as of the effective date of the plan.\(^{236}\) and that confirmation of the plan will not likely be followed by a further liquidation or reorganization of the reorganized entity.\(^{237}\)

If the plan meets all provisions of subsection 1129(b), the court must confirm the plan,\(^{238}\) although there is considerable scope within subsections 1129(a) and 1129(b) for the court to find some basis on which to reject the plan.

The cram down provisions are rarely used.\(^{239}\) However, the provisions are valuable as a threat, as the consequences of failing to negotiate and arrive at an acceptable plan may seriously affect all parties in interest.\(^{240}\) Thus, with the threat of cram down being ever-present, the parties will usually negotiate a plan with a view to having it accepted and confirmed under subsection 1129(a).

Cram down requires the court to balance diverse interests and ensure that the plan protects all parties as far as is possible in the circumstances. The tests that the courts apply in attempting to balance these diverse interests illustrate the complexity of applying the concept. Whether the plan is to be confirmed under the provisions of subsection 1129(a) or subsection 1129(b), it must meet the

\(^{234}\) Code s. 1129(b)(1).

\(^{235}\) *Ibid*

\(^{236}\) Code s. 1129(a)(7)(A)(ii), which is known as the "best interests of creditors" test.

\(^{237}\) Code s. 1129(a)(11), which is known as the "feasibility" test.

\(^{238}\) *In re Stoffel*, 41 B.R. 390 (Bankr. D. Minn. 1984). The court, in that case, found that not all of the requirements had been met. See also, K.N. Klee, "All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code" (1979) 53 Am. Bankr. L.J. 133 at 140-141.

\(^{239}\) Norton Bankruptcy Law & Practice s. 93:1.

\(^{240}\) For an excellent analysis of the risks incurred by the parties and the possible negative impact of a cram down, see R.F. Broude, "Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative" (1984) 39 Bus. Law. 441.
feasibility and the best interests of creditors tests. If the proponent is seeking to cram the plan down, the plan must also be fair and equitable and must not discriminate unfairly. We will examine the components of each of these tests.

The feasibility test is found in paragraph 1129(a)(11) of the Code which provides that a plan will be confirmed only if:

Confirmation of the plan is not likely to be followed by the liquidation, or the need for further reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.

This provision requires that confirmation must "buy more than temporary relief for the debtor." To satisfy this requirement, the debtor must tender evidence of its projected cash flow and earnings to show that it will fulfil its obligations under the plan. This requirement is not unlike the requirement under the BIA for the insolvent person to submit a cash flow statement. The court must carefully review the assumptions upon which the evidence is based to ensure that the assumptions are reasonable in the circumstances. The prospective nature of this examination makes it "an estimate compounded by a guess." This provides the court with a great deal of flexibility in deciding whether to confirm the plan.

The best interests of creditors test requires that, for a plan to be confirmed, each member of an


242 Broude, supra note 240 at 448. See also In re U.S. Truck Co., Inc., supra note 192 at 589, where the court listed the following factors as germane to its inquiry as to the future viability of the reorganized firm:

1. the adequacy of the capital structure;
2. the earning power of the business;
3. economic conditions;
4. the ability of management; and
5. any other related matters which determine the prospects of a sufficiently successful operation to enable performance of the provisions of the plan.

243 BIA s. 50.4(2) to (5).

244 House Report at 225.
impaired class:

. . . will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date. 245

This test seeks to ensure that each member of a dissenting class, as opposed to the class as a whole, receives at least as much as that member would receive on a liquidation. To satisfy the best interests of creditors test, the plan proponent must tender evidence showing the liquidation value of the debtor's assets and the distribution of that value among the creditors. 246 This valuation must show that the plan treats the creditors at least as well as they would be treated in a liquidation. This evidence is plagued by the same intangible concerns as the feasibility test.

The final two tests apply only if the plan proponent seeks to use the cram down provisions, which provide:

Notwithstanding section 510(a) of this title, if all the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan. 247

Paragraph 1123(a)(4) 248 requires the plan to treat members of a class the same and thus, it deals with unfair discrimination among class members. The fair and equitable test deals with unfair discrimination among disparate classes and holds that all classes maintain their relative priority vis-a-
vis other classes of claims and interests.\textsuperscript{249} The unfair discrimination prohibition requirement set forth in subsection 1129(b) applies in respect of classes of equal rank.\textsuperscript{250} The prohibition against unfair discrimination forbids the plan proponent from treating substantially similar classes differently, unless there is good reason for so doing.\textsuperscript{251} One may take the position that any plan that separately classifies similarly situated claim or interest holders is discriminatory to one of the classes. However, the plan proponent has the burden of proving that the discrimination is not "unfair."\textsuperscript{252} Provided there is a reasonable basis for the discrimination, that it is necessary to a successful reorganization and that the plan is proposed in good faith, the court may allow the discrimination.\textsuperscript{253} However, the court may disallow the discrimination should the plan proponent not satisfy the burden of proof.\textsuperscript{254}

The final test, which is "the key to cram down,"\textsuperscript{255} is the fair and equitable test. The words "fair and equitable" are words of art that have acquired a specific meaning through judicial

\textsuperscript{249} *Northern Pacific Railway Company v. Boyd*, 228 U.S. 482 at 504 (1912). The "fair and equitable" or "absolute priority" rule will be discussed, infra notes 258-285 and accompanying text.

\textsuperscript{250} House Report at 416. The House Report recognized that the problem inherent in both the "unfair discrimination" test and the "fair and equitable" test would be in attempting to establish whether a class maintains a priority position over or is subordinate or equal to another class. It appeared to leave the question open to be dealt with on a case by case basis by saying "One aspect of this test that is not obvious is that whether one class is senior, equal, or junior to another class is relative and not absolute." [at 416]. This, it is submitted, is the root of the problem that plagues the classification issue which is discussed in chapter VI(C)(2), above.


\textsuperscript{252} Ibid.


\textsuperscript{254} See e.g., *Pine Lake*, supra note 194, where the plan attempted to separately classify trade debt and a secured creditor's unsecured deficiency claim; *In re Economy Cast Stone Co.*, 16 B.R. 647 (Bankr. E.D. Va. 1981), where the plan attempted to place the claim of an insider in the same class as trade creditors.

In particular, they require a plan to maintain absolute priority among creditors and interest holders. The essence of the concept of absolute priority is that a class of creditors may assert its priority rights against a subordinate class of creditors or against all classes of interest holders. Of course, in a complex reorganization, this statement may be more difficult to apply than to state. However, it illustrates that the court must be keenly aware of the priority ranking of the various creditors and interest holders.

Congress codified the fair and equitable concept in paragraph 77B(f)(1), although the concept developed in equity receiverships before the enactment of section 77B. That paragraph provided that a judge could confirm a plan if satisfied, inter alia, that "it is fair and equitable and does not discriminate unfairly in favour of any class of creditors or stockholders, and is feasible." Given the similarity between this paragraph and subsection 1129(b) of the Code, the case law preceding the passage of the Code continues to have precedential value in any case applying the fair and equitable standard. The fair and equitable standard only applies in a cram down situation. In other words, if no party objects to the plan, adherence to the absolute priority rule is unnecessary.

To confirm the plan under Chapter X, the proponent had to satisfy the court that the plan was fair and equitable, whether or not any party objected to it. In other words, the absolute priority rule was invioable and the parties had no latitude to negotiate other arrangements in derogation of the rule. This required a valuation hearing in all Chapter X cases to ensure compliance with the absolute

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258 See *Louisville Trust Co. v. Louisville, New Albany and Chicago Railway Company*, 174 U.S. 674 at 684 (1899), where the United States Supreme Court described it as the "familiar rule" that "the stockholder's interest in the property is subordinate to the rights of creditors; first of secured and then of unsecured creditors."


260 Chandler Act s. 221(2).
priority rule. This step was criticized in many of the discussions leading up to the passage of the Code as expensive, time-consuming, imprecise and discouraging negotiation. Thus, the policymakers drafted the Code in a way that would avoid the application of the fair and equitable test and its concomitant requirement for a valuation hearing if all parties consent to the plan. The absolute priority rule would apply only if a class of impaired creditors or interest holders objected to the plan and then, only to the affected classes. A senior class could agree to a junior class receiving more than the junior class would receive on an application of the absolute priority rule, so long as any intervening class receives the full value of its claims. The rule does not apply to classes senior to the objecting creditor or interest holder. Thus, it is in the best interest of all parties to negotiate a plan that the requisite majorities will accept. This may mean that senior creditors should allow junior creditors or interest holders to receive something under the plan, even if on a liquidation or under the fair and equitable test, they would receive nothing. This would avoid the costs of a valuation hearing that erode the amount otherwise payable to the senior creditors and would ensure an expeditious conclusion to the case.

The Code specifies factors to be considered in determining whether a plan is fair and equitable in respect of a class of creditors or interest holders. The factors depend on whether the dissenting


262 V. Brudney, "Bankruptcy Commission's Proposed 'Modifications' of the Absolute Priority Rule" (1974) 48 Am. Bankr. L.J. 305 at 314, where the author said:

"...the absolute priority rule restrains seniors from making compromises under which juniors are allowed to participate before the seniors are fully compensated, and requires that the enterprise be valued - as realistically as possible - before determining which classes may participate in the reorganized enterprise and how much they are entitled to receive."

263 Code s. 1129(a).


impaired class consists of secured creditors, unsecured creditors or interest holders.

To be fair and equitable to a class of secured creditors, subparagraph 1129(b)(2)(A) requires that the plan provide:

(i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totalling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on the proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

For all the alternatives, a valuation of the secured collateral is necessary. The Code provides no guidance as to whether the value should be the going concern or liquidation value. Subclause 1129(b)(2)(A)(i)(II) adds to this uncertainty. It requires the debtor to make deferred cash payments to the creditor that must, at least, be equal to the amount of the allowed secured claim and have a present value equal to the value of the collateral. This requires the court to choose an appropriate present value.

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266 B. Weintraub and A.N. Resnick, "Cram Down of the Unsecured Creditor: Section 111(b)(2) Relief" (1983-84) 16 U.C.C.L.J. 159 at 160. The authors posit the following example:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>current amount outstanding</td>
<td>$15MM</td>
</tr>
<tr>
<td>original collateral value</td>
<td>$18MM</td>
</tr>
<tr>
<td>current collateral value</td>
<td>$12MM</td>
</tr>
</tbody>
</table>

In this scenario, the lien would remain on the collateral securing the amount of $15MM. The deferred cash payments must have a face amount of $15MM and have a present value of $12MM. Although the present value of the deferred payments are only $12MM, eventually, the debtor must pay off the full secured amount which is $15MM.

This result assumes that the secured creditor makes an election under subsection 1111(b) of the Code. Recall that under subsection 506(a) of the Code, an undersecured creditor's claim is treated as bifurcated. That is, the claim is considered secured up to the value of the collateral and is unsecured for the balance of the claim. This value is fixed as at the date of the filing of the petition and as such, the secured creditor will not be in a position to take advantage of any appreciation in the value of the collateral after that date. Under subsection 1111(b), the undersecured creditor may elect to have its entire claim treated as secured, which results in its unsecured portion being waived. However, making the election will allow the creditor to take advantage of any possible appreciation in the value of the collateral up to the full value of its claim and prevents the debtor from "cashing out" the creditors in
value rate and the rate necessary to calculate the payments to the secured creditor while the debtor is performing its obligations under the plan.\(^{267}\)

For the plan to be fair and equitable under clause 1129(b)(2)(A)(i), the plan need not provide the secured creditor with its strict contractual rights. In such a case, the creditor would be considered unimpaired and resort to the fair and equitable standard would be unnecessary.\(^{268}\) The plan may rewrite the contract, for example, to extend the term or adjust the interest rate closer to the market rate, provided always that the stream of payments being made to the creditor has a present value equal to the present value of the secured claim.\(^{269}\)

The second way for the plan to be considered fair and equitable to a dissenting impaired secured creditor is under clause 1129(b)(2)(A)(ii) where the plan contemplates a sale of the collateral, free and clear of liens, with the liens attaching to the proceeds. The plan must treat the lien on the times when the market for the collateral is weak.

\(^{267}\) These rates may be the market rate for either minimal, good or terrible risks. The courts do not seem to have agreed on the appropriate rates to be used in these circumstances. See e.g., In re 222 Liberty Associates, supra note 251 at 994 (current market rate); In re Monnier Brothers, 755 F.2d 1336 at 1338 (8th Cir. 1985) (contract rate); In re Mitchell, 77 B.R. 524 at 525, 527 (Bankr. E.D. Pa. 1987) (the lesser of the contract rate and the rate of yield for treasury bills due to mature on the date of termination of the debtor's plan); In re Jordan, 130 B.R. 185 at 192 (Bankr. D.N.J. 1991) (cost of funds to the creditor). Choosing the appropriate rate requires the court to make the fundamental determination of which parties should bear the risk of future performance by the reorganized debtor. In other words, the rate of interest payable to the creditor should be higher if the court perceives that the risk should be borne by the parties that will ultimately stand to gain the most from the reorganization. Again, the secured creditor's interest in the reorganized debtor is finite and is determined by the ultimate value of the collateral. Should the reorganized debtor meet with significant success, the interest holders will be the beneficiaries of the success and should therefore bear the risk of the future performance by the debtor. See D.G. Baird and T.H. Jackson, "Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy" (1984) U. Chi. L. Rev. 97. See also, In re D. & F. Construction, Inc., 865 F.2d 673 (5th Cir. 1989), where the court held that the alternatives in subparagraph 1129(b)(2)(A) were non-exclusive and refused to hold that the plan was fair and equitable notwithstanding that the provisions of that subparagraph may have been "literally met." [at 675]. In so doing, the court did not give the words "fair and equitable" their meaning as words of art, but imposed a broader, more literal meaning.

\(^{268}\) Norton Bankruptcy Law & Practice s. 93:7.

\(^{269}\) Ibid.
proceeds in one of the other fair and equitable standards discussed herein. Under subsection 363(k), to which clause 1129(b)(2)(A)(ii) is subject, the secured creditor may bid at the sale and if successful, offset its claim against the purchase price of the collateral.

The final way of satisfying the fair and equitable standard is to provide the secured claimant with the indubitable equivalent of its allowed secured claim under clause 1129(b)(2)(A)(iii). In the event the secured creditor makes the election under subsection 1111(b) of the Code, that gives it a secured claim on the collateral for the full amount of its claim, the plan will meet the indubitable equivalent standard only if the debtor provides payments, replacement liens or other property or consideration equal to the value of the debt. The legislative history suggests that the plan may meet the standard by returning the collateral to the secured creditor, as the value of the secured claim is necessarily equal to the value of the collateral securing the claim.

Under subparagraph 1129(b)(2)(B) of the Code, a plan will be considered fair and equitable to a class of unsecured creditors if:

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

Simply stated, the plan must provide the unsecured creditor with property equal in value to the

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270 See discussion, chapter V(A)(1)(b), above, that describes the concept of "indubitable equivalent."

271 Supra note 266.

272 The court in In re Sun Country Development, Inc., 764 F.2d 406 at 409 (9th Cir. 1987), allowed the debtor to provide the secured claimant with substitute collateral in order to satisfy the indubitable equivalent standard. However, the Bankruptcy Court for the District of North Dakota would not permit the debtor to undertake the same strategy in In re Hoff, 54 B.R. 746 at 753 (Bankr. D.N.D.).

allowed amount of the claim or alternatively, property of a value less than the full amount of the
claim, provided junior creditors or interest holders receive nothing under the plan. The latter
alternative is a codification of the absolute priority rule.\textsuperscript{274} Difficulties arise if, in seeking to obtain the
consent of all creditors, a senior class agrees to give up some of its value to a junior class of creditors
or interest holders. If an intervening class does not receive the full amount of its claim under the plan,
the plan cannot be confirmed on the basis that a class lower in priority to the intermediate class is
receiving some value.\textsuperscript{275}

Finally, subparagraph 1129(b)(2)(C) provides for the fair and equitable treatment of a class of
interest holders. That subparagraph provides that the plan is fair and equitable if:

(i) the plan provides that each holder of an interest of such class receive or retain on
account of such interest property of a value, as of the effective date of the plan, equal to the
greatest of the allowed amount of any fixed liquidation preference to which such holder is
entitled, any fixed redemption price to which such holder is entitled, or the value of such
interest; or

(ii) the holder of any interest that is junior to the interests of such class will not receive or
retain under the plan on account of such junior interest any property.

This standard is not unlike the fair and equitable standard applicable to unsecured creditors. However,
given that the claims of interest holders are generally the most junior, it appears that any plan that
eliminates ownership interests under clause 1129(b)(2)(C)(ii) would be confirmed. However, as
interest holders are receiving nothing under the plan, they are deemed to have rejected the plan.\textsuperscript{276}

Accordingly, they could force a valuation hearing, which, because they are receiving nothing under the
plan, costs them nothing and erodes the debtor's property that would otherwise be available to
creditors. Should the valuation hearing indicate that there is equity in the reorganized entity, a class of
creditors is necessarily receiving more than the full value of its claims, to the detriment of the interest

\textsuperscript{274} Norwest Bank of Worthington v. Ahlers, 485 U.S. 197 at 202 (1988), rev'g 794 F.2d 388 (8th Cir. 1986) [hereinafter Ahlers]. See also In re Snyder, 967 F.2d 1126 at 1128 (7th Cir. 1992).


\textsuperscript{276} Code s. 1126(g).
holders. Thus, the plan cannot be confirmed. Practically, this gives the interest holders a significant amount of bargaining leverage that may prompt a senior class of creditors to give up some value to the interest holders to secure their consent.

Debtors commence the vast majority of reorganization cases in both Canada and the United States. Unless the debtor is a large publicly-held corporation, the principals of the debtor are also its major shareholders. Thus, part of the reorganization plan usually gives the former shareholders some interest in the reorganized debtor. For the former shareholders to retain an interest in the reorganized debtor, it will be necessary for the plan to follow the absolute priority rule, which means that the plan must pay in full all claims and interests senior to the shareholders. The courts have created an exception to this general rule however, known as the "new value" exception to the absolute priority rule. This exception was created by L.A. Lumber which established that the following criteria must be present for the new value exception to operate:

1. the debtor must have a need for the new value contribution;
2. the ownership interest retained or received must be the fair equivalent of the contribution made; and
3. the contribution must be in money or money's worth.

The court held that the intangible contributions of the former owners to the reorganized entity would not satisfy the criteria and accordingly, the test is obiter dictum. However, the case has found

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277 Norton Bankruptcy Law & Practice s. 93:14.

278 In the event that the debtor is clearly insolvent, it has been suggested that a party in interest seek a "preemptive cram down" which summarily eliminates the interest holder from the reorganization process and prevents it from seeking a value for its valueless interest through negotiation, L.M. LoPucki and W.C. Whitford, "Preemptive Cram Down" (1991) 65 Am. Bankr. L.J. 625.

279 Supra note 256.

280 Ibid at 121-122; see also, In re 222 Liberty Associates, supra note 251 at 984-985.

281 Ibid at 121-122.
considerable support under the Code.\textsuperscript{282}

If \textit{L.A. Lumber} is considered the seminal case that established the new value exception prior to the passage of the Code, \textit{Ahlers}\textsuperscript{283} is the case that established the exception under the Code. However, like \textit{L.A. Lumber}, the court in \textit{Ahlers} refused to allow the former shareholders the right to retain an interest under the plan on the basis that their "labor, experience and expertise"\textsuperscript{284} was not new value. Thus, the two leading cases that purportedly establish and maintain the new value exception actually refused the shareholders the right to use it. This has prompted a debate as to whether the new value exception even exists under the Code.\textsuperscript{285} However, as the court in \textit{Ahlers} held that an intangible contribution will not constitute new value and most principals of the debtor have few personal assets to contribute to the reorganized debtor, it is difficult to imagine this being a significant issue. It will only become an issue if the shareholders are able to obtain outside financing that will allow them to contribute "money or money's worth," in which case, the existing creditors benefit from the enhanced value or at least the new value protects their interests in the interim.

Should we import the concept of cram down into Canadian reorganization law? The answer to this question depends on how far the policymakers wish to go in making reorganization part of Canadian commercial culture. This section has attempted to illustrate that the cram down mechanism is not simply an exercise in looking at the plan, determining whether it is fair or reasonable and then "cramming it down" on recalcitrant creditors. In fact, it is a very complex analysis upon which the

\textsuperscript{282} See \textit{e.g.}, \textit{In re Snyder}, supra note 274 at 1128-1131, where the court discusses the history and present status of the new value exception. In so doing, it makes a strong argument for the continued existence of the exception under the Code. See also \textit{In re Landau Boat Co.}, 13 B.R. 788 at 791-794 (W.D. Mo. 1981); \textit{cf. Greystone}, supra note 194 at 142.

\textsuperscript{283} \textit{Supra} note 274.

\textsuperscript{284} \textit{Ibid.} at 199. It should be noted that the United States Supreme Court specifically refused to rule on whether the new value exception survived the enactment of the Code [at 203 n. 3].

\textsuperscript{285} See \textit{e.g.}, \textit{In re Sovereign Group 1985-27, Ltd.}, 142 B.R. 702 (E.D. Pa. 1992) and \textit{In re Bonner Mall Partnership}, 142 B.R. 911 (D. Idaho 1992), that held that the new value exception survived the passage of the Code, and \textit{In re A.V.B.I., Inc.}, 143 B.R. 738 (Bankr. C.D. Cal. 1992), which held that the new value exception did not survive passage of the Code.
entire structure of Chapter 11 is based. One author called cram down the "heart of chapter 11."

To attempt to import certain aspects of the cram down without analyzing the entire system and individual mechanisms embodied in Chapter 11 would have chaotic and unjust results. Accordingly, this paper does not advocate the importation of cram down without a thorough analysis of all aspects of Chapter 11.

We have seen that the prospect of a cram down rather than the actual mechanism is a useful tool in the United States. A simpler mechanism that gives the court discretion to impose a plan on recalcitrant creditors should there be improper motives for rejecting a plan may produce the same results. The discretion exercised by the courts, which allows them to disregard votes of creditors improperly exercised or obtained, is a form of cram down already used in this country. In other words, if a class rejected a plan and the court finds that the members of the class constituting the majority did not cast their votes in good faith, the court essentially imposes the plan on the class by disregarding the will of the majority. However, if there are valid business reasons for the class rejecting the plan, it is difficult to see why the court should be able to impose the plan on the rejecting class.

The answer to this concern from an American perspective is the fair and equitable or absolute priority rule. With the predominance of secured credit in Canada, as opposed to the more prevalent equity financing that is found in the United States, the absolute priority rule may be practically meaningless. In most cases, a secured creditor can control the reorganization proceedings simply because it has all of the assets encumbered by its security interests. Because of its unique position, it will be in a separate class and usually, it will dominate the unsecured creditor class because of the shortfall in its security position. Accordingly, rejection by the secured creditor will defeat the plan in any event. A requirement that the plan follow the absolute priority rule in such circumstances will doom any plan to failure.

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286 Miller, supra note 255 at 1063.
Cram down is useful, as demonstrated in the United States for almost a century. However, the entire reorganization system facilitates its use. Without importing the entire system that supports it, the cram down mechanism cannot work equitably.
CHAPTER VII
CONCLUSION

The Code is presently under attack, by the academic communities and policymakers. Professor Elizabeth Warren perhaps best summed up the reason for the attack as follows:

After twelve years of experience with the new Bankruptcy Code, people are angry with the bankruptcy process. Creditors are angry with debtors who have resisted payment and thwarted their collection efforts. Employees are angry with companies that have laid them off while the big boys remain in their high paying jobs. Tort victims are angry with companies because they are not getting enough money to compensate them for all that they have lost. Judges are angry with the disputants because they have neither the time nor the resources to monitor the cases in their care. And everyone is angry with the lawyers because they are getting rich.

The attack has taken place on two levels. The first is on Chapter 11 itself and its results. The "first shot" in this attack came from an article published in the Yale Law Journal in 1992. This article was based on empirical evidence that caused the authors to conclude that the business reorganization process:

1. was inefficient because of the costs incurred in completing the procedure and the length of time that the procedure takes;
2. encourages mismanagement before and after commencement of the proceedings;
3. does not protect the parties to the bankruptcy proceedings; and

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2 Bills were passed in 1992 by the Senate and the House that would have created a National Bankruptcy Review Commission to provide Congress with suggested amendments to the Code. The bills had differences that were resolved, but the compromise bill was not passed because of the end of the legislative session. On September 15, 1993, however, the Bankruptcy Amendments Act of 1993 received approval of the Senate Judiciary Committee. This legislation seeks to rectify some of the problem areas that have been identified in the case law and by commentators over the 16 years of the Code's existence, but it does not suggest that Chapter 11 be repealed. The passage of this proposed legislation "is quite a way from approval by both the Senate and the House." [M.M. Sheinfeld, "October 3, 1993 Supplement to the Future of Chapter 11: Tensions in Reorganization Practice" [unpublished]]. However, this suggests that Congress has recognized a need to amend the current system employed by the Code.


4 Bradley and Rosenzweig, supra note 1.
4. encourages bad faith filings because of the easy access that debtors have to the courts. These propositions caused an immediate response from commentators who criticized the methodology of the authors, and the analysis of the data obtained.

The second level of attack is based on bankruptcy policy. On the leading edge of this attack are Professors Thomas Jackson and Douglas Baird. This attack is founded in law and economics and focuses on the fact that a reorganization proceeding does not result in an efficient deployment of the debtor's assets. It assumes that a bankruptcy system should mirror an agreement that the creditors would negotiate among themselves concerning the deployment of the assets of the debtor. The creditors would seek to avoid collection costs and risks of losing the race to the swiftest that occurs in state collection proceedings, and settle instead for perhaps less than full recovery by using the collective proceeding of bankruptcy. However, creditors and interest holders would likely not choose reorganization. They would likely choose a liquidation of the assets of the debtor, given the costs attendant on a reorganization proceeding, the time required to complete it and the "potential distortions from a fictive valuation of a firm" that is necessary in any reorganization proceeding. Professor Baird summed up a criticism of reorganization policy on this level as follows:

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5 Warren, supra note 3.


8 Creditors' Bargain, ibid. at 860. Professor Jackson refers to this as the "creditors' bargain model." See also Uneasy Case, ibid. at 127-128.

9 Creditors' Bargain, ibid. at 863-864.

10 Uneasy Case, supra note 7 at 128.
... reorganizations provide breathing space for troubled enterprises. They do not exist to implement the investors' bargain ... Rather, they exist to prevent the creditors' individual (or collective) interests from destroying a firm as a going concern by forcing it to liquidate piecemeal, destroying both jobs and assets in the process. Bankruptcy law, under this view, tries to ensure that a firm survives, quite apart from whether the owners as a group want it to or not ... This approach to bankruptcy law frequently seems to assume that we are better off if a particular firm stays in business. It does not squarely face the possibility that all interested parties might be better off as a group if the firm's assets were put to a different use.11

To avoid leaving the reader with the false impression that Chapter 11 has no defenders, one must note that the foregoing approaches have their own critics.12 The "loss distribution theory" espoused by Warren13 denounces the simplistic approach taken by Baird and Jackson that bankruptcy law is meant to rationalize the problems encountered in debt collection. It sees the bankruptcy process as attempting to accommodate and effectively sort out, not only the interests of creditors, but also a broader range of interests,14 such as tort claimants, "unemployable" employees, customers, adjacent property owners and the like.15 Warren's "traditional view"16 has been described as follows:

According to the Traditional view, the only "system" at work in the law of bankruptcy is one that provides for the case-by-case adjustment, realignment, and reformulation of bankruptcy purposes along functional lines. It seems fair to state, then, that the Traditional view regards the central purpose of bankruptcy, if it can be called that, as the apportionment of losses occasioned by firm collapse according to a set of principles, none of which is pre-eminent by definition.17

Warren, describes her theory as "a dirty, complex, elastic, interconnected view of bankruptcy from which I can neither predict outcomes nor even necessarily fully articulate all the factors relevant to a

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11 Uneasy Case, supra note 7 at 134.
12 See e.g., supra note 6.
14 Ibid. at 777.
15 Ibid. at 787-788.
17 Ibid. at 961-962.
policy decision." However, this should not derogate from the utility of her theory, as it reflects the complex web of bankruptcy law in practice.

Contemporary law reformers must consider Warren's approach. That approach appears to raise more questions than answers and the questions raised confront squarely the normative considerations that underlie bankruptcy reform. Clearly, there is no correct answer to these inquiries and the "most correct" answers depend on whether one approaches the issue from the perspective of the debtor, a creditor, an equity interest holder or some other third party affected by the process. The fundamental question posed by Warren is:

... if the justification for bankruptcy is also distributional, the relevant inquiry is necessarily larger: what are the values to be protected in the distributional scheme, and is the implementation scheme effective?\(^\text{19}\)

If law reformers are not prepared to consider this fundamental premise, bankruptcy reform will merely be a piecemeal composite of various rules with no unified objective. With respect, the latest amendments to the proposal provisions of the BIA have resulted in this type of regime.

This chapter briefly and superficially referred to the foregoing theories to show that there is no unity among American scholars concerning the policies underlying a bankruptcy system and whether a business reorganization system serves any useful purpose. Bradley and Rosenzweig went so far as to suggest the repeal of Chapter 11.\(^\text{20}\) This paper will not debate the issue of whether or not Congress should repeal Chapter 11. In fact, one must question the role of a Canadian bankruptcy practitioner in the debate. However, the debate points to a serious failing of Canadian policymakers in amending the former Canadian Act. As mentioned previously, the process of bankruptcy reform in Canada started in 1966 with the formation of the committee that produced the Tassé Report. Although Parliament did

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\(^{18}\) Warren, supra note 13 at 811.

\(^{19}\) Warren, supra note 13 at 796.

\(^{20}\) Bradley and Rosenzweig, supra note 1 at 1078, where the authors said "[c]hapter 11 should be repealed: abolishing court-supervised corporate reorganizations and, in effect, precluding residual claimants from participating in any reorganization of the firm."
not enact major amendments until 1992, it made the amendments hastily and without thoroughly understanding the normative considerations outlined by Warren. Furthermore, it appears that certain aspects of Chapter 11 and the CCAA were incorporated into the BIA without careful consideration of the how those provisions work within the host system.

As a result, the BIA is a piecemeal composite of mechanisms that do not address vital issues and place restraints on the courts that will not allow the development of equitable concepts. One wonders whether the policymakers felt that business reorganization was a necessary part of a bankruptcy and insolvency system, given the opting-out rights of secured creditors and the overt protection accorded to landlords. The flexibility of the CCAA at least encourages the parties to attempt to reach a workable solution. The priority payments, opting-out rights and requirement for an independent proposal trustee under the BIA and the costs attendant on a proceeding under the CCAA have resulted in Canada having no reorganization regime available for the average Canadian debtor; only the "elite" may reorganize! If the policymakers conclude that the Canadian business community wants a reorganization system, they must enact legislation to accomplish the objective of making the system accessible to all debtors.

It may be trite to say that a person drafting legislation must have a thorough knowledge of the objectives of the proposed legislation and the means of accomplishing them. In the preparing the amendments to the former Canadian Act, the policymakers had access to two comprehensive reports of the current and proposed bankruptcy regimes. The Tassé Report and the Colter Committee Report set forth objectives of bankruptcy legislation which show the delicate balancing required of the person drafting the legislation. On the extreme ends of the spectrum are the respective interests of the debtor and its creditors and somewhere within the spectrum are larger societal interests. Those considering future amendments to the Canadian business reorganization regimes would be well advised to reacquaint themselves with those reports.

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Neither the Code nor the CCAA are models that the policymakers should seek to emulate entirely in any reforms to the BIA. An analysis of these models points to weaknesses and vague references that Canadian policymakers should seek to avoid. However, there are certain aspects of each of those models and the cases decided thereunder which should be considered important to any reorganization regime. In particular, the concept of adequate protection seeks to balance the diverse interests involved in a reorganization proceeding. If properly framed, the concept will facilitate the reorganization efforts of the debtor by protecting those that are most likely to challenge the efforts and encouraging parties to provide financial support to the debtor. In addition, the parties in interest should control the reorganization proceeding, not an independent third party that has little or no interest in the fate of the debtor or its creditors. The parties in interest should determine whether interjection of an independent person is necessary or desirable. Finally, as reorganization is a collective proceeding, the conduct or motives of a party or group should not determine the fate of the reorganization. Whether the debtor has proper motives in commencing the proceeding or a creditor is seeking to obtain some unfair advantage, should not form the basis for a dismissal of the proceeding. Instead, once the plan proponent commences the proceedings, the interests of all parties and the benefits accruing from a reorganization must be considered. The legislation must provide personal sanctions against the offending party. As presently framed, the CCAA has the necessary flexibility to accomplish these objectives; the BIA does not.

The objectives of this paper were twofold. First, to show that in formulating any proposals for reform of a business reorganization system, it is useful to look beyond the statutes and case law developed domestically. This notion is neither new nor original in bankruptcy reform. The *Bankruptcy Act, 1949*[^22] "was based on the study of bankruptcy legislation of other countries, particularly that of England, Australia and the United States."[^23] The analysis should be functional, in

[^22]: S.C. 1949, c. 7.

the sense that the policymakers should conduct a thorough study of the legislation, case law and commentaries, to appreciate the impact of the provision under consideration. This suggested methodology was illustrated in this paper.

More importantly, however, as a prelude to that study, Canadian policymakers must wrestle with the fundamental question of whether the Canadian commercial community even wants a system of business reorganizations. In this regard, the policymakers should refer to the debates in the American law journals concerning bankruptcy and reorganization policy. In addition, the process of bankruptcy reform has also begun in the United States. Canadian policymakers should keep themselves apprised of developments in that regard. In particular, Canadian representatives should attend or review the proceedings of any Congressional hearings. If the policymakers see business reorganizations as desirable, for whatever reason, the next step is to determine the values that will be protected and the legislative method of effectively protecting those values.

Chapter 11 does not resolve all of the foregoing issues. However, it provides us with illustrations of how we may or may not want to reform our business reorganization systems. Ultimately, there is no reorganization system that will pacify all constituencies. Undertaking the thorough study suggested by Edwards at the outset of this paper may not provide us with the "fairest and most feasible scheme possible" but it will allow us to justify the scheme ultimately adopted.