



# Municipal Insolvency in Canada

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The COVID-19 pandemic is projected to have a devastating impact on the Canadian economy. A recent report released by the Parliamentary Budget Officer indicated that the federal deficit could exceed \$250 billion in 2020-21 and that Canada's GDP could contract by as much as 12 percent.<sup>1</sup> These projections should come as no surprise given the effective shutdown of the Canadian economy and the financial measures adopted by all levels of government to limit the economic impact of the pandemic.<sup>2</sup>

Much of the focus regarding the pandemic's impact has been on the federal and provincial governments. However, municipalities are not immune to the resulting economic challenges. Most municipal employees and services have been deemed essential by the federal government. At the same time, municipalities have been forced to close certain revenue generating facilities and many have offered property tax deferrals.

Under these circumstances, municipalities across Canada are struggling to find the resources to meet their financial obligations. Recently released data by the Federation of Canadian Municipalities (FCM) found that cities across Canada are facing a minimum shortfall from anywhere between 10 to 15 billion dollars as a result of the pandemic.

Unlike other levels of government, municipalities have limited revenue-generating tools available to them and are constrained by provincial legislation which, among other things, prohibits budgetary deficits. Not surprisingly, municipalities have been actively lobbying for additional provincial and federal financial support, with some mayors, including the mayor of Vancouver, suggesting that if they do not receive financial assistance their cities are at risk of 'going bankrupt.'

Due in large part to the aforementioned financial constraints placed on municipalities, Canada has not had any notable municipal bankruptcies to date. That said, Canadian municipalities have experienced insolvency in the past. During the 1930's, several municipalities, including higher-profile cities such as Windsor, York, and Burnaby, defaulted on payments to creditors.<sup>3</sup> In these cases, the municipalities either restructured their financial affairs outside of the formal restructuring processes available under insolvency legislation or amalgamated with smaller adjoining cities.

Municipalities will likely encounter unprecedented economic losses as a result of the pandemic. What happens if a city is unable to restructure its financial affairs outside of the formal regimes established under Canada's insolvency legislation? What legal remedies are available to these municipalities? The answer, as it turns out, is somewhat unclear.

#### PROVINCIAL LEGISLATION PERTAINING TO FINANCIALLY DISTRESSED MUNICIPALITIES

Legislative authority in Canada is divided between the federal and provincial governments based upon subject matter. While bankruptcy and insolvency is a federal responsibility, municipal governance falls within the exclusive jurisdiction of the provinces.

Unsurprisingly, a number of provinces have enacted legislation that deals with the management of distressed municipalities.<sup>4</sup> For example, Ontario, Quebec, and several other provinces have passed legislation which places distressed municipalities under the control of municipal boards. The municipal boards are responsible for conducting inquiries and managing the financial affairs of distressed municipalities. To date, there is no evidence to suggest that these boards have been relied upon in any meaningful way.



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While many provinces have enacted legislation dealing with the management of insolvent municipalities, bankruptcy and insolvency falls under the purview of the federal government. Municipalities could potentially benefit from the formalized restructuring regimes under Canada’s insolvency legislation. However, there is some uncertainty as to whether municipalities can rely on Canada’s insolvency legislation.

### CAN STRUGGLING MUNICIPALITIES RELY ON INSOLVENCY LEGISLATION?

For the most part, Canadian municipalities have been fiscally healthy since the mid-20th century. As a result, there is no recent case law that deals with the issue of whether insolvent municipalities can rely on existing bankruptcy legislation.

Notably, in early case law dating to the mid-1930’s, the courts held that insolvent municipalities could not rely upon the Bankruptcy and Insolvency Act (BIA),<sup>5</sup> the principal federal legislation governing bankruptcy in Canada. One of the reasons that the courts held that municipalities could not rely on the BIA was that municipal corporations did not fall within the narrow definition of ‘corporation’ under the BIA, which, prior to amendments in 1997, required that the corporation be incorporated for the exclusive

purpose of ‘carrying on business.’ As municipalities are not incorporated for the exclusive purpose of ‘carrying on business,’ it followed that they did not fall within the definition of ‘corporation’ as it was then defined in the BIA.<sup>6</sup>

However, the 1997 amendments to the BIA removed the requirement that the corporation be incorporated for the exclusive purpose of ‘carrying on business.’ Although it has yet to be determined by the courts, there is an argument to be made that municipal corporations now fall under the scope of the BIA, which would allow insolvent municipalities to restructure their affairs through a formalized process.

### ADVANTAGES GRANTED UNDER THE BIA & COMPANIES’ CREDITORS ARRANGEMENT ACT

If applicable, the BIA or the Companies’ Creditors Arrangement Act (CCAA) – federal legislation that governs the restructuring of larger or complex corporate entities<sup>7</sup> – could provide municipalities with much needed flexibility to restructure their affairs and recover from the financial difficulties caused by the pandemic.

It is important to note that bankruptcy – often confused with the concept of insolvency – is a



legal status carrying with it specific consequences. Debtor entities, including municipalities, are not 'bankrupt' merely as a result of being unable to meet their financial obligations, but rather, can become bankrupt by:

- i. making an assignment under the BIA for the benefit of creditors;
- ii. unsuccessfully attempting a restructuring under the BIA; or
- iii. being subject to a bankruptcy order made under the BIA.<sup>8</sup>

Municipalities that indicated that they are at risk of 'going bankrupt' are likely projecting cash shortfalls that may lead to an inability to make payments with respect to certain financial obligations. In other words, these municipalities are likely forecasting periods where they may be insolvent, one of the prerequisites to rely on the provisions of either the BIA or the CCAA.

The distinction between insolvency and bankruptcy is important. It is not likely that an insolvent municipality would make a voluntary assignment in bankruptcy before every effort was made to obtain financial assistance from the provincial government. Although bankruptcy is likely not an appropriate solution for insolvent municipalities, restructuring under either the BIA or CCAA may very well be an appropriate solution.

Generally speaking, a debtor entity that initiates a restructuring under either the BIA or CCAA is granted a stay of proceedings against its creditors, which allows the debtor to develop and present a plan of compromise to its creditors.<sup>9</sup> If approved by creditors, then the plan is presented to the court, and, if sanctioned, the debtor entity may continue normal business operations having compromised its indebtedness.

Importantly, restructuring under either the BIA or the CCAA provides a number of flexible remedies which could benefit insolvent municipalities, including the following:

- Stay of proceedings as against unsecured and secured creditors, which would allow a struggling municipality to develop a plan of compromise;
- Interim financing: where a debtor has insufficient cash to operate during its BIA or CCAA proceedings, the legislation permits the courts to authorize interim financing to assist with financial obligations;
- Disclaimer of agreements: A debtor may disclaim an agreement to which it is a party as of the day it enters into BIA or CCAA proceedings;
- Critical suppliers: A debtor can apply to the court to have a person declared a critical supplier, and if deemed a critical supplier, the court may order the person to supply goods and services on terms and conditions that are consistent with the supply relationship that existed prior to the restructuring or on terms and conditions that the court considers appropriate, despite missed payments or other existing defaults by the debtor; and
- Assignment of agreements: A debtor can apply to the court to have contracts with third parties assigned without the consent of such third parties.

The foregoing are but a few examples of the flexibility afforded under the restructuring regimes of the BIA and the CCAA. These regimes are designed to enable debtor entities to restructure their financial affairs so that they can return to normal operations after the restructuring is completed. In the case of municipalities, resort on these statutory regimes may afford the needed flexibility to assist in weathering the economic impact of the pandemic.



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## SUMMARY

Municipal insolvency is incredibly uncommon in Canada. As a result, there is considerable uncertainty as to how such an insolvency can and shall be handled. Indeed, the issue of whether municipalities can rely on existing insolvency legislation has not been decided and the common unknown is whether provinces will simply step in to provide the necessary financial assistance to avoid such a circumstance from arising.

However, what if a province is not financially able to provide the necessary economic back step for a municipality? Given that all levels of government are being subjected to an unprecedented economic challenge, the financial resources may not be available to assist municipalities.

In the near future we may very well see municipalities seeking to take advantage of the restructuring tools available to corporations under the BIA and CCAA as the same may offer desperately needed relief.

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