Some Preliminary Considerations
When Contemplating The Restructuring Of A Business

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The restructuring landscape in Canada is changing.

New market dynamics are poised to have a significant influence on efforts to effect successful business restructurings.

Changing creditor composition, an expanding role for the Crown, difficulties in obtaining financing and a depressed market for distressed assets (especially real estate) have resulted in new and different challenges for debtors and creditors seeking to effect a successful restructuring.

To survive the next wave of corporate restructurings, debtors and their stakeholders will need to learn to deal with an increasingly divergent number of participants in the restructuring process, to identify and meet the emerging communication demands of these participants, to understand the relative priorities of the stakeholders and to recognize that liquidation may no longer be an attractive alternative.

With the rapid and unexpected downturn in the economy that was precipitated by the collapse of the asset backed commercial paper market in the fall of last year, it is fair to say that we will have the opportunity over the next year to see first hand how the changing restructuring landscape will affect the success or failure of distressed businesses which are attempting to survive through these turbulent economic times.

Identifying The Players And Their Different Interests

In recent years, there has been a perceptible shift in the nature and number of participants in Canadian corporate restructurings.[1] Gone are the days when a distressed business had a single lender and negotiations on a loan workout were handled across the account manager's desk at the local bank branch.

Modern debt structures tend to be far more complex than in previous years. It is not uncommon for a mid-size business to have multiple lenders each with differing interests, maturity rights and rights of repayment, and each with potentially different objectives respecting the debtor's business and property.[2] For example, it is not uncommon for a business to have an operating lender, one or more subordinated secured lenders, equipment lessors, ordinary trade creditors, leasehold financing from a landlord and, more often than not, a significant debt to the federal and/or provincial Crown.

Until the debt market collapsed in the fall of last year, banks routinely sold non-performing loans to secondary market participants (such as distressed investors, private equity and hedge funds), which, in turn, would frequently resell these loans to other third

[1] Edward A. Sellers, "Significant Changes Expected In Next Wave of Canadian Corporate Restructurings" (2008), Vol. 25, No. 1 & 2, National Insolvency Review, 1 (LN) ("Sellers")
[2] Sellers, *ibid*, at 2.

party market participants. The emergence of this secondary debt market added a new dimension to the restructuring process.

The purchasers of distressed debt tend to have a very different mind set and objectives than a traditional lender. The overriding motivation for such lenders is a high return on the "investment" that it has made through the debt purchase. In the first instance, this will manifest itself in a more aggressive pricing structure for the distressed business, but with continued financial deterioration, this may well evolve into a "loan to own" strategy whereby the lender will end up swapping its debt (or a portion of it) for a controlling equity interest in the distressed business.

With the evaporation of the secondary debt market, distressed businesses find themselves in an unenviable and unprecedented position. Neither the distressed business nor its senior lenders have access to a readily available market to either refinance or off-load the existing debt.

In view of the foregoing, principals of distressed businesses and their lenders are being forced to address the underlying problems plaguing the business and, of necessity, make the hard choices that until recently they may have deferred or avoided entirely by simply taking advantage of the readily available refinancing alternative.

Both distressed businesses and their senior lenders must also be mindful of the priorities and motivation of other stakeholders. For example, it has become apparent that the federal and provincial Crowns are taking a much more active role in restructuring and liquidation proceedings.

The nature and scope of Crown priority claims is the subject of the presentation to be given by Jeffrey Lem later in this program so we will not go into any great detail on the subject. However, it is important to note that the super-priority status given to the statutory deemed trusts for unremitted source deductions and goods and services tax ("**GST**") (at the federal level) and retail sales tax ("**PST**") (at the provincial level) will oftentimes be an important consideration in determining a restructuring strategy.

While the super-priority status in favour of the federal Crown for unremitted source deductions will survive the bankruptcy of a distressed business and continue to rank ahead of all security interests [3], the same is not the case with the deemed trusts for unpaid GST and PST which are reduced to unsecured claims.

However, when formulating a recovery strategy, senior lenders should be aware of the recent British Columbia Court of Appeal decision in *Ted LeRoy Trucking*. [4]

In this case, the debtor company commenced proceedings under the *Companies Creditors Arrangement Act* [5] (the "**CCAA**"). As is typical in CCAA proceedings, the initial order obtained in the proceedings effected a stay against all creditors while the debtor company was attempting to restructure its affairs.

[3] With the possible exception of the security interests granted by a Court to a debtor-in-possession lender.
[4] *Re: Ted LeRoy Trucking Ltd*., B.C.C.A. (May 7, 2009) (Docket No. CA036474).
[5] R.S., 1985, c. C-36

The debtor company owed the federal Crown in excess of $300,000 in respect of unremitted GST.

As part of its restructuring efforts, the debtor company received authorization from the Court to sell certain of its redundant equipment and to distribute the proceeds of such sales to its senior secured creditor, Century Services Inc. ("**CSI**").

The federal Crown opposed the distribution of the proceeds on the basis that, in the absence of a bankruptcy, it had priority to the subject proceeds. Over the objection of the Crown, the Court ordered that the sales proceeds be distributed to CSI with approximately $300,000 to be held by the court appointed monitor in a trust account pending a judicial determination as to entitlement.

Several months later, the debtor company came to the realization that it could not successfully reorganize its financial affairs. Accordingly, it applied for court approval to distribute the balance of its sales proceeds and for leave to assign itself into bankruptcy.

Not surprisingly, the Crown brought a contemporaneous application for the payment to it of all proceeds held in trust by the monitor. The chambers judge granted the relief sought by the debtor company and dismissed the application of the Crown.

In his reasons for decision, the chambers judge held that the trust monies held by the monitor were only segregated to facilitate payment of the GST in the event of a successful plan of arrangement. As a result of there being no viable plan, the priority of the Crown was held to be reversed on the bankruptcy of the debtor company in accordance with the provisions of the *Bankruptcy and Insolvency Act*[6] (the "**BIA**").

The British Columbia Court of Appeal disagreed. While recognizing that, generally speaking, a deemed trust in favour of the Crown for GST is not effective in a bankruptcy situation, the Court of Appeal found that: (1) after the restructuring efforts came to an end, the chambers judge did not have a discretion to ignore the deemed trust under section 222 of the *Excise Tax Act*[7]; and (2) the order which required the approximately $300,000 of sales proceeds to be held in trust by the monitor constituted an actual or express trust that should have been recognized by the chambers judge.

The Court of Appeal decision in *Ted LeRoy Trucking* will come as an unpleasant surprise to many insolvency practitioners who have operated under the assumption that a bankruptcy will always serve to reverse the deemed trust super-priority in favour of the Crown for GST.

We would be remiss if we failed to mention the increasing importance of two other participants in many restructurings: employees and debtor-in-possession lenders (the "**DIP Lender**").

[6] R.S., 1985, c. B-3
[7] R.S., 1985, c. E-15

While employees have always been an essential part of any restructuring, it is only since the passage of the *Wage Earners Protection Plan Act*[8] ("**WEPPA**") in July of 2008 that employees have been afforded a statutory priority interest over the interests of secured creditors. Under WEPPA, an employee is entitled to claim from the government a maximum of $3,000 (or four times the maximum weekly insurable earnings amount under the *Employment Insurance Act*[9]), less amounts prescribed by regulation, for unpaid wages in the six months prior to the employer's bankruptcy or receivership. Until recently, the definition of 'wages' under WEPPA was limited to salaries, commissions, compensation for services rendered, and vacation pay. However, amendments made on March 12 of this year[10] have expanded this definition to include both severance pay and termination pay.[11]

Under this new regime, an employee's wage claims are considered to be a secured claim, to a current maximum of $2,000, with a super-priority over all other creditors.[12]

The super-priority rights of employees have the potential to significantly reduce the amounts recoverable by secured lenders and other stakeholders in a bankruptcy or receivership situation. Consequently, the amount of credit that lenders will be willing to extend may be negatively impacted, particularly in cases where a business employs a large labour force.

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[8] 2005, c. 47, s. 1

[9] 1996, c. 23

[10] See the *Budget Implementation Act*, 2009, c. 2, s. 342, as published in Statutes of Canada (2000), *Canada Gazette* (Part III), Vol. 32 No. 1, May 5, 2009, 567

[11] Per Section 2(1) of WEPPA, the definition of 'wages' also includes any other amounts prescribed by regulation.

[12] See Sections 81.3 and 81.4 of the BIA. In addition, employee claims for unremitted employer pension contributions now also receive a super-priority. These claims have no maximum limit.

Indeed, lenders will likely take steps to adjust current lending terms and practices to take into consideration the new employee super-priority. The form of these adjustments will be varied: some lenders may lend based on a reduced value of the assets, or require debtors to provide additional security for existing credit facilities. Others may intensify monitoring practices, particularly those used with higher risk debtors (i.e. those debtors with a large workforce), and require employer debtors to confirm wages, pension contributions and government remittances are paid on a timely basis.[13]

Last, but by no means least, the DIP Lender has become a regular participant in Canadian restructuring proceedings.

The DIP Lender is called upon to provide working capital financing to distressed businesses that are under insolvency protection when the existing lenders have chosen not to extend any further facilities.

For this service, the DIP Lender will typically charge an interest premium and require that it have a first ranking security interest in the assets of the distressed business (including a priority over the super-priority deemed trust claims of the federal and provincial Crowns). [14]

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[13] Matthew Lem, "WEPPA: Wage Protection for Employees, Credit Constriction for Employers", *Canadian Manufacturers and Exporters 20/20*, Nov - Dec 2008, online: <http://www.bdo.ca/library/publications/articles/manufacturing/WEPPA120808.cfm>

[14] Jonathan A. Levin, "Subordination, Priorities and Super-Priorities: An Update" (2008) Vol. 25, No. 1 & 2, National Insolvency Review, 3 (LN)

Needless to say, there is a developing body of law which addresses the circumstances in which a DIP Lender should be entitled to a priority position and to what extent, but such a discussion is beyond the scope of this paper.

Suffice it to say that in the next wave of business restructurings, we expect that the DIP Lender will play a prominent role. For distressed debtors it is worth noting that a DIP Lender does not necessarily care whether a restructuring is successful, only that if it fails, the liquidation value of the debtor's assets will be sufficient to retire the indebtedness owing to it.

With all of these varied stakeholder interests placed into the mix, restructuring business debtors, lenders, and other stakeholders involved in the restructuring must be cognizant of how each stakeholder competes with, and, potentially, complements one another. It is not sufficient for participants to simply identify key stakeholders; there must also be an understanding of each player's motivation in the restructuring.

Clearly, identifying which parties maintain an active interest in a debtor's affairs requires more scrutiny then in past down credit cycles. Understanding the business objectives of such parties will prove even more challenging. To effectively weather the current downturn in the economy, debtors must adopt an approach that affords them sufficient flexibility to cater to the various business objectives, interests and expectations of all concerned stakeholders. To accomplish this objective, implementing effective communication strategies becomes critical.

Communication Is Essential

Distressed businesses and creditors must remember that the fundamental goal of a restructuring (either formal through a statutory framework or informal through a creditor driven forbearance process) is to allow the business to emerge as a viable commercial entity. Where the distressed business has not been proactive in dealing with its key constituents it runs the risk that these key constituents will decide that their best interests are served by taking enforcement steps to recover the indebtedness owing to them at the expense of the distressed debtor.[15]

In most cases, senior (and other) lenders are provided with regular financial information relating to the profitability and performance of the distressed business. Where management is able to analyze the company's financial data and identify a potential underperformance issue, it is almost certain that lenders will (eventually) reach the same conclusions. Timely disclosure may be a debtor's best strategy.

The most critical step in disclosing a problem is managing the approach and method of disclosure. Breaking the news of financial difficulty to one's creditors is never an easy task. Nevertheless, such disclosure remains the most critical task a distressed debtor must undertake. Failure to ensure one's key constituents are on-side from the onset of a financial problem will likely result in a failed restructuring. Creditor cooperation and approval is essential for success in an informal restructuring, and key constituents can

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[15] Wes Treleaven, "Turning a Company Around: the CFO and the Restructuring Process" (1999) I.I.C. – Art. 1999-8 ("Treleaven")

defeat a potentially successful formal restructuring plan if there is no confidence or trust in the management of the distressed business.

The dilemma facing the distressed business is how soon is too soon to ring the alarm bells? Speak too soon (and before a viable restructuring strategy is developed), and creditors may become unnecessarily spooked, and this can exacerbate a problem by interfering with funding sources. Delay too long and creditors may learn of the financial difficulties through their own analysis or through secondary sources, and feel misled or deceived. A strategic debtor will recognize that the quickest way to burn the bridge to a successful restructuring is to alienate one or more of its senior stakeholders.

Before any disclosure is made, a debtor should ensure that it knows what to say to each of its stakeholders. Internal and external communications must be effectively managed to protect and bolster the distressed debtor's already questionable credibility. Although it is not necessary to make full disclosure to every stakeholder, there must be consistency in the information and going forward strategy which is disclosed to all participants. Debtors need to bear in mind that there is a degree of interaction and informal information sharing in the credit community, and the restructuring process can often be more transparent than a debtor would like. Any discrepancies will come to light and may serve to derail an otherwise successful restructuring.

Information must be both reliable and substantive. Simply opening the lines of communication with creditors is not enough. If a distressed debtor is to win the support of its stakeholders, communication to and with such stakeholders must include specifics of the financial difficulties, including the scope of the problem, the curative steps to be followed and the likelihood of a timely and successful resolution.

To be credible, the principals of the distressed business must convince the stakeholders that they have a sophisticated understanding of all financial aspects of their business. Unfortunately, the reality is that the vast majority of Canadian businesses, regardless of size, do not have ready access to reliable and useful financial information. Even more alarming is the fact that most debtors cannot produce timely and reliable monthly statements, performance reports, or internal reports accounting for where and how cash resources have been utilized.[16]

All organizations need to have access to an integrated financial model, which includes a balance sheet, a profit and loss statement and cash flow forecast, each of which when reviewed together provide creditors with a real time picture of the financial situation. The distressed debtor's financial model is the focal point for all communications with its stakeholders; it is through this information that the debtor will be able to educate its stakeholders on the issues the debtor is facing and instill in the stakeholders a degree of confidence that the financial challenges can be met.

The other obvious benefit of up to date and concise financial information is that it provides the distressed debtor with the ability to predict its short and long term cash needs (i.e. knowing timeframes as to when authorized credit lines will likely be

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[16] Treleaven, *ibid*, at 2

exceeded). A debtor that is caught off guard by its own financial state is in a position to do more damage to its business and its credibility than any current market factors.

Irrespective of its form, communication is more effective if information is able to flow regularly and honestly between a debtor and its creditors. This is imperative for a debtor as a consistent and honest exchange of information is the most vital step in regaining credibility with stakeholders. Significant delays or the dissemination of unreliable or misleading information can undermine relationships and cause the restructuring process to fail before the requisite reparative steps have been taken.

Lending relationships are not just based on security valuations, but on confidence.[17] Credit defaults, particularly in the current distressed market, are not only common but anticipated in many situations and it is the manner in which the debtor responds to these challenges that will dictate the level of confidence that its secured lenders (and other stakeholders) have in the debtor. In most cases, the level of such confidence can determine the success or failure of a restructuring.

The Necessity of Being Proactive

Much has been written on the subject of debtor denial. Less, if anything, has been written about lender denial. However, lender denial does exist and it is seen every day by bankers who toil in the special loans departments of our financial institutions.

[17] Treleaven, *ibid*, at 2

More often than not, debtors are permitted to operate their businesses with little to no effective monitoring of their financial position, despite the usual covenants, ratios and reporting obligations found in typical commercial loan agreements.

Since the market down turn began at the end of last year, it is fair to say that more emphasis is being placed by credit managers on becoming acquainted with their customers' financial performance. This renewed emphasis is due in no small part to the fact that replacement financing is now no longer readily available and non-performing accounts are not as easy to exit from a financial institution as they were when the credit market had greater liquidity. As a consequence, it is likely that non-performing loans will be transferred on a more timely basis to the special loans bankers who are better trained to address insolvency related issues.

Accordingly, it is clear that both distressed debtors and their lenders can benefit from taking a more proactive approach to a deteriorating financial position.

For a business debtor, being proactive means:

- having an integrated financial model that allows immediate access to real time information on the fiscal position of the business;

- monitoring this real time information to identify negative trends when they begin;

- having a strong CFO and accounting team that can correctly assess and analyze the real time information;

- understanding the nature of each and every loan commitment and other contractual obligations which bind the distressed debtor;

- appreciating the respective priorities and underlying motivation of each stakeholder;

- opening a dialogue with each stakeholder that identifies the financial challenges facing the distressed debtor and providing a feasible road map to returned profitability.

For senior lenders and other key stakeholders of a business debtor, being proactive means:

- understanding the nature of the business debtor's operations and having an appreciation for how the current economic climate will affect profitability;

- visiting the principals of the debtor and making enquiries as to the status of the business operations;

- reviewing and analyzing the financial data provided by the business debtor;

- ensuring that the failure of the business debtor to honour any payment or reporting obligations is "red flagged" and an immediate follow up made to determine the cause;

- being prepared to work cooperatively with a business debtor (and other stakeholders) to make whatever amendments need to be made to existing loan agreements or other contractual relationships to recognize and adapt to the changing financial position of the business debtor.

Earlier recognition of a negative financial trend by both a distressed debtor and its stakeholders may provide an opportunity to reverse such a trend through the implementation of strategic cash and/or asset management without the requirement to embark upon a formal restructuring process.

Of course, there will be many situations where the cause of the financial difficulty is due to circumstances which are not readily reversible. For example, in recent times, many Canadian businesses have seen increased competition from Chinese competitors and, for exporters, the strength of the Canadian dollar against its US counterpart has caused many markets to dry up. In these most severe of cases, formal wholesale restructuring may be unavoidable.

<u>New Considerations in a Down Market</u>

The current recession presents some unique challenges.

Throughout the market downturns of the 1980’s and 1990's, distressed business debtors had access to replacement financing (albeit with premium pricing penalties) and senior lenders were able to maximize recoveries through operating receiverships.

Not so today. The collapse of the capital market in the fall of last year has severely restricted access to debt financing and secured lenders are still struggling with the chill that has befallen operating receiverships since the *<u>TCT Logistics</u>*[18] decision, in which the Supreme Court of Canada held that receivers may be considered successor employees despite protective language in appointment orders.

What does this mean?

In our view, until liquidity returns to the capital markets and/or the long overdue amendments to the BIA and the CCAA are proclaimed in force and receivers are comfortable operating businesses again, more emphasis will be placed on consensual work out arrangements. Of necessity, senior lenders and other stakeholders of a distressed debtor may feel obliged to work with an honest but unfortunate debtor in an

[18] *GMAC Commercial Credit Corporation – Canada v. T.C.T. Logistics Inc.*, [2006] 2 S.C.R. 123, 2006 SCC 35

attempt to weather the immediate financial crisis with a view to a longer horizon on the return to profitability.

Although the Canadian experience with distressed real estate is vastly different than that of our neighbours in the United States, there is no doubt that lender appetite to advance credit facilities on the strength of real estate value has waned considerably since the onset of the sub-prime mortgage crisis. Debtors who once felt comforted by the fact that their real property holdings guaranteed continued lender support no longer have this level of comfort. Indeed, while a lender may consider giving a debtor more time to restructure its affairs in consideration for additional or "shore up" security on real property, this will not be the determinative factor for continued support.

In the final analysis, there are rarely any quick fixes and certainly no easy refinancing options for today's business debtor. Band-Aid solutions do not work, particularly in a distressed market. Sometimes dramatic action is required to rehabilitate the core of a business. The watch words for distressed businesses and their stakeholders should be cooperation and transparency coupled with a pro-active approach to resolving the pressing financial challenges faced by the debtor. To avoid the unpleasant consequences of a business failure, debtors and their stakeholders alike must be ready – and willing – to meet the changing demands of these unprecedented times.