CREDITOR RIGHTS AND THE PUBLIC INTEREST

Restructuring Insolvent Corporations

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1 The Existing Regime for Restructuring Insolvent Corporations

> The word *bankruptcy* is derived from the Italian *banca rotta* when medieval merchants would have their marketplace benches broken if they defaulted on payments. Restructuring suggests that debtors' benches should be fixed, not broken, and that creditors should be treated fairly, recognizing their diversity of interests.
>
> Karen Gross[1]

> *Creditori e lavoratori insiemi possono riparere il banco, per aumentare il suo valore.*[2]

Insolvency systems are an indispensable component of commercial economies, and the particular system adopted by a jurisdiction usually reflects economic and societal choices regarding how to address firm failure.[3] Insolvency law thus forms an important part of the corporate governance regime, because it regulates governance of an insolvent corporation during the key period of decision making about its future. This chapter examines the historical origins of Canada's restructuring regime in order to situate the current theoretical debate and to gain insight into the underlying purposes of Canadian insolvency law. It provides an overview of the current scheme for workouts of insolvent corporations and the role of the judiciary in developing notions of the public interest.

At the heart of Canada's insolvency law lies an early twentieth-century statute. The *Companies' Creditors Arrangement Act* (*CCAA*), enacted in 1933, acknowledged broad interests in an insolvency but left unresolved how these interests should be recognized. The Act, moreover, essentially fell into disuse, until debtor corporations and secured creditors discovered it as a valuable restructuring tool in the late 1980s. Recently, the courts have recognized the interests of non-traditional creditors or stakeholders, utilizing terms such as the 'public interest' or 'social stakeholders.' This re-emergence in the past decade of recognition of interests broader than traditional creditor and shareholder interests is an important development in the law. But it raises the questions of how the public interest is to be defined and measured, and what the scope of judicial decision making should be. Judicial consideration of public interest has also engendered criticism from some senior creditors and their legal counsel. There was a high level of support for decision making that protected secured creditor interests to the exclusion of almost all other interests, and attempts to accommodate broader interests have been construed by some as judicial overreach. These issues are discussed in the chapters that follow.

Origins of the Canadian Restructuring Regime

The historical origins of the Canadian insolvency regime offer insight into the original purposes of restructuring legislation. The legislation of 1933 anticipated the importance of a scheme that recognizes multiple investments in the corporation and offers a mechanism to avoid premature liquidation, in which the insolvent corporation is liquidated even though the value that would accrue to satisfy creditors would be greater if the firm were to continue in operation. The original legislation endorsed the notion that it was in the public interest to afford corporations the opportunity to reorganize as an alternative to liquidation. The historical perspective also provides a foundation on which to explore the current theoretical debate about the underpinnings and efficacy of restructuring statutes.

The enactment of the *CCAA* in 1933 must be understood in the context of previous bankruptcy legislation.[4] A federal *Bankruptcy Act* had been enacted in 1919 after an almost forty-year gap in national bankruptcy legislation.[5] The impetus for this legislation was a wave of commercial failures, following which creditor groups lobbied for national consistency in the administration of bankrupt estates. This legislation was thus a product of private initiative, not public policy, driven by creditors who wanted to ensure that where they worked out arrangements with debtor companies, they had the ability to bind minority and dissenting creditors through court orders.[6] The 1919 bankruptcy legislation applied, for the first time, to both companies and individuals, and allowed debtors to make compromise proposals prior to bankruptcy, subject to creditor approval and court sanction. A formal mechanism to allow debtors to negotiate a proposal with creditors and the availability of bankruptcy discharge meant that creditors were able to preserve, where possible, the companies as future debtors. However, the effectiveness of this early legislation was undermined: it did not bind secured creditors, who could defeat a proposal by moving to enforce their claims.[7]

The rehabilitation provisions of the *Bankruptcy Act* received little scrutiny at the time, the focus being on the efficient administration and liquidation of estates and the forgiveness/punishment role of bankruptcy.[8] Amendments enacted in 1923 in response to abuses of debtors and unqualified trustees disallowed proposals for restructuring or compromise before bankruptcy.[9] Given the difficulty of reviving a company once it is bankrupt, the amendments resulted in defeat of almost all efforts to restructure financially distressed companies, leading in turn to a number of premature liquidations. By 1933, the *Bankruptcy Act* and the *Winding Up Act* essentially provided only for liquidation of a company under a trustee in bankruptcy or a liquidator.[10] Yet growing capitalization and concentration of wealth in existing enterprises meant that when a firm experienced financial difficulty, the effects of dissolution of the company were economically more important than they had been in previous years. While the drive for legislative change came from debtor corporations seeking a means to restructure prior to bankruptcy, it was also recognized that firm failure affected not only the owners of the company, but creditors and employees as well. Thus the *CCAA* was introduced to facilitate compromises and arrangements between companies and their creditors.

In introducing the *CCAA* in 1933, Secretary of State C.H. Cahan noted that the limited mechanisms under existing statutes inevitably resulted in the entire disruption of the corporation, loss of goodwill, and sale of assets on a discounted basis.[11] There had been no means by which creditors could reach an amicable settlement in such a way as to permit the company to continue in business through reorganization. The Act was introduced because of the 'prevailing commercial and industrial depression' and was intended to promote adoption of a method by which the courts could supervise arrangements between creditors and debtor corporations without the improvident sale of assets of the firm. The legislation was based on the British *Companies Act of 1929*, which provided for compromises with creditors, setting out value amounts of support required before the courts would endorse a plan.[12] Interestingly, the enactment of the *CCAA* parallels the 1933–4 revisions to U.S. bankruptcy legislation that codified large-scale corporate reorganization for the first time. (The U.S. courts had, for almost half a century, used the common law concept of equity receiverships to allow for the restructuring of insolvent railway companies.)[13] References to reform of U.S. bankruptcy law are absent from the Canadian legislative debates. But in the United States, as in Canada, the impetus for reform came largely from credit industry organizations that lobbied aggressively for an enhanced debt collection structure. Support for restructuring measures was part of the compromise between pro-creditor and pro-debtor interests that legislators on both sides of the border were instrumental in effecting.

The Canadian government was careful not to encroach on provincial jurisdiction and the 1933 legislation did not address share reorganizations or shareholder votes. The court was empowered, however, to hear applications proceeding conjointly under the *CCAA* and provincial corporations law, in order to facilitate compromises and arrangements. Creditors were to be grouped in classes having the 'same interest,' to allow them to decide among themselves the terms of compromise of their interests.[14] One of the express purposes of the legislation was to provide a mechanism to bind both secured and unsecured creditors, provision for which was lacking under pre-existing bankruptcy legislation.

The original *CCAA* bill was widely circulated throughout Canada in advance of its introduction and it passed speedily through Parliament. The House of Commons Debates are scanty and no minutes were recorded for the proceedings of the Standing Committee on Banking and Commerce.[15] Indication of an awareness of the public interest involved is more prominent in the Senate Debates on the *CCAA*. The Honourable Arthur Meighen, in presenting the government's bill, said: 'the depression has brought almost innumerable companies to the point where some arrangement is necessary in the interest of the company; in the interests of employees, – because the bankruptcy of the company would throw the employees on the street, – and in the interest of