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Debtor in Possession Financing: The Jurisdiction of Canadian Courts to Grant Super-Priority Financing in *CCAA* Applications

Restructuring of insolvent corporations can be an effective means of avoiding the social and economic consequences of firm failure. Key to successful restructuring is financing (called DIP financing) in the interim period during which the corporation is attempting to develop a viable business plan that is acceptable to stakeholders. Canadian courts have exercised their inherent jurisdiction to grant such financing. A recent case before the Supreme Court of Canada settled. However, there continue to be challenges to the courts' jurisdiction. This article suggests that the degree of uncertainty created by the courts' granting of DIP financing has been exaggerated and that the courts have engaged in a reasoned effort to further the aims of the CCAA in protecting the interests of all creditors and the public in the continued operation of corporations where the prospects of successful reorganization exist.

La restructuration des entreprises insolvables peut s'avérer efficace pour pallier aux pertes économiques et aux coûts sociaux liés à la déconfiture de l'entreprise. La réussite de la restructuration tient à l'apport des capitaux nécessaires à la survie et au redressement de l'entreprise (appelé arrangement de financement pour débiteur en possession de ses biens) pendant la période intérimaire où celle-ci tente de mettre au point un plan d'exploitation viable que les actionnaires jugeront acceptables. Les tribunaux canadiens sont habilités à établir des ententes concordataires de ce genre et sont donc à même d'intervenir. Dans une cause récente dont était saisie la Cour suprême du Canada, les parties en sont venues à une entente. Néanmoins, la compétence des tribunaux en la matière est sans cesse contestée. L'auteur estime que l'on a beaucoup exagéré le degré d'incertitude associée aux arrangements de financement pour débiteur en possession de ses biens consentis par les tribunaux. De fait, les tribunaux ont tout mis en oeuvre pour concrétiser les objectifs de la Loi sur les arrangements avec les créanciers des compagnies et veillent ainsi aux intérêts des créanciers et du public en permettant aux entreprises de poursuivre leurs activités lorsque la tentative de restructuration court de bonnes chances de réussir.

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Introduction

The restructuring of insolvent corporations can benefit diverse creditors, including secured lenders, employees and trade suppliers, if a workout can be negotiated that will ultimately enhance value to creditors. As a consequence, Canadian insolvency legislation is aimed at facilitating a workout process. One part of the process to negotiate a plan of arrangement or compromise under the *Companies' Creditors Arrangement Act* is the granting of interim financing during the stay and negotiation period.[1] Such financing allows the debtor corporation to carry on operations pending a workout, referred to as debtor in possession (DIP) financing.[2] However, some creditors are questioning the jurisdiction of the court to order such financing as a priority charge in the absence of express legislative direction on this issue.

This article examines the debate in light of the recent judgment by the British Columbia Court of Appeal in *Re United Used Auto & Truck Parts*.[3] The Court of Appeal affirmed the provincial Supreme Court's decision that it had jurisdiction to grant priority financing. The Supreme Court of Canada granted leave to appeal, without reasons, however, the matter settled before hearing. Yet there continue to be cases in which the court's jurisdiction is challenged. The question is whether a court dealing with a *CCAA* application has jurisdiction to order priority payment and DIP financing without the debtor obtaining the consent of creditors, in order to facilitate the restructuring objectives of the *CCAA*, given the scheme of creditors' priorities enshrined in the *Bankruptcy and Insolvency Act*.[4] More recently, the federal government has announced that it is considering codifying or restricting the court's jurisdiction to grant DIP financing through statutory amendment; discussed in Part VI below.

1. *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as am. by S.C. 1997, c. 12 [hereinafter *CCAA*].
2. The DIP financing question is also an issue under the proposal provisions of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as am. by S.C. 1997, c. 12 [hereinafter *BIA*]. However, it appears as if almost all of the cases have been decided under the *CCAA*. Rotsztain suggests this is because practitioners have concluded that the rule-driven restructuring process under the *BIA* leaves no room for the exercise of the court's inherent jurisdiction. Michael B. Rotsztain, "Debtor-in-Possession Financing: Current Law and a Preferred Approach" (2000) 33 Can. Bus. L.J. 283 at 284.
3. *Re United Used Auto & Truck Parts Ltd.*, [2000] S.C.C.A. No. 142, leave to appeal to S.C.C. granted without reasons September 14, 2000, Supreme Court File No. 27824, [hereinafter *Re United Used Auto* (S.C.C.)]; *Re United Used Auto & Truck Parts Ltd.*, [2000] 5 W.W.R. 178 (B.C. C.A.) [hereinafter *Re United Used Auto* (B.C. C.A.).
4. *BIA*, *supra* note 2.

This article suggests that the *CCAA* and the *BIA* are different statutes with different legislative objectives and a different legislative scheme for achieving those objectives. The *BIA* creates a comprehensive regime that deals with the enforcement of claims during receivership and bankruptcy, with provisions for a workout of individual and commercial insolvencies. It does not address the priorities of claims in the period of an interim stay under either its own proposal provisions or the provisions of the *CCAA*. Parliament enacted the *CCAA* and the *BIA* as complementary statutes and neither is subordinate to the other. To suggest that the courts have compromised the rights of senior creditors by the granting of proportionately small priority financing to facilitate the aims of the *CCAA* is to ignore the entire statutory scheme of the *CCAA* and the *BIA*. There is a public policy aspect of the *CCAA* that goes beyond the protection of creditors' priorities on bankruptcy and that policy has been articulated in courts and Parliament. Specifically, the legislation is aimed at facilitating the development of a feasible business plan to allow the corporation to continue in business where there is potentially greater value generated for creditors and the public.[5]

The argument that DIP financing and administration charges of monitors prejudice creditors is actually an argument that it prejudices secured creditors. While the argument has a certain appeal, it does not stand up to closer scrutiny. That is because the objectives of the *CCAA* are to facilitate a workout, and are aimed at protection of a broad range of creditors such as trade suppliers, consumers, employees, landlords and local governments. Moreover, there are cases in which DIP financing is granted where the value of secured creditors' claims has been greater under a restructuring than a liquidation. The argument that the priorities are interfered with is not compelling, except when courts make an error in granting access to the process at the front end. The courts' process for adopting DIP financing provides more than adequate protection for the interests of creditors without having to grant a veto to secured creditors by requiring their consent. Moreover, in the absence of a legislative provision, it is wrong to grant secured creditors a veto because it is important to advance all of the goals of the *CCAA*. If only the interests of the secured creditors are considered, it would tip the balance too much at the wrong point in the procedure.

5. Janis Sarra, *Creditor Rights and the Public Interest, Restructuring Insolvent Corporations* (S.J.D. Thesis, University of Toronto Law School 1999) [unpublished], at 21-25.

Part I of this article discusses what is meant by priority or DIP financing in the insolvency context. Part II situates the DIP financing debate by setting out the different objectives of the *BIA* and the *CCAA* and discusses how these statutes complement one another. Part III then considers the rationale currently used by the courts for the granting of DIP and other priority financing. Part IV examines the challenge to the court's jurisdiction in the *Re United Used Auto* case. Part V then examines why Canada should not move to the U.S. model for the granting of priority financing. Finally, Part VI suggests that there are principles that can be distilled from the courts' reasoning that are a useful interpretive guide to approaching requests for priority charges and DIP financing. The article concludes that the courts' approach to these cases has generally been a balanced exercise of jurisdiction. Legislation is not necessary for the continued exercise of court jurisdiction to approve DIP financing. Nevertheless, legislative guidance would increase certainty in creditors' dealings with insolvent corporations seeking to reorganize.

I. *DIP Financing and other Priority Charges during Insolvency*

Debtor in possession financing has become the short form for several types of financing during the period that a corporation is attempting to work out its affairs with its creditors. DIP financing generally refers to financing to carry on operations during a brief period under the stay provisions of the *CCAA* while the corporation attempts to negotiate a plan of arrangement or compromise with its creditors.[6] This is frequently granted where continuing with business operations is necessary to preserve the value of the business and assets of the corporation, preserve customer and supplier goodwill, and retain employees with the experience and expertise to assist in a turnaround. Generally an insolvent business is worth more as a going concern, whether it is successfully restructured under its existing equity structure or sold as a going concern, rather than liquidated on a piecemeal sale of the assets.

In some cases, DIP financing may be directed towards an environmental maintenance program pending the workout. This is particularly true in the resource industries, where inaction in terms of environmental maintenance could cause considerable harm to the environment and surrounding communities. Thus, even where DIP financing is not sought to

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6. Many of the same issues regarding financing also apply to the proposal provisions under the *BIA*, which also provides a stay period and a process distinct from bankruptcy and the realization of claims. The discussion in this article focuses primarily on the *CCAA*.

continue business operations, priority financing has been aimed at protecting or ensuring compliance with environmental obligations, an aim clearly in the interests of the public.[7]

Interim or DIP financing during the workout period cannot realistically be left purely to private contract once a court grants a stay under the *CCAA*. Given that the corporation is already insolvent when it enters proceedings under the *CCAA*, it is difficult to obtain additional financing unless the creditor, whether an existing secured creditor or a new creditor, receives some priority in terms of securing the credit. At the point of insolvency, credit is a much riskier proposition than when a corporation is solvent, and thus lenders of DIP financing are able to extract a premium, *i.e.* priority financing in exchange for advancing the money. However, where all of the corporation's assets are already subject to secured creditors' claims such new private financing will not be available. Yet when the court orders DIP financing, a concern is why existing secured creditors should assume additional risk without having a vote or veto on whether they wish to acquire this risk. As the discussion in Part IV will illustrate, at first glance this argument has appeal, but it may not withstand closer scrutiny.

The other principal kind of priority charge is for the reasonable fees and disbursements of the court-appointed monitor under a *CCAA* application. This typically also includes the legal and professional fees of the monitor. Under the *CCAA*, a court appoints a monitor, who performs a role similar to that of a trustee under proposal provisions of the *BIA*. The court has discretion to direct the monitor to perform duties such as acting as liaison with creditors, assisting in the formulation of a restructuring plan, facilitating negotiations with creditors, and giving an opinion on the debtor corporation's ability to meet the requirements of a revised business plan.[8] Although appointment of a monitor had become accepted practice in *CCAA* applications, it became mandatory with the 1997 amendments to the *CCAA*.[9] The role of the monitor is defined by statute and includes

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7. For example, in *Royal Oak Mines*, a portion of the DIP financing was aimed at environmental protection; *Re Royal Oak Mines*, [1999] O.J. No. 1364 (Gen. Div. [Commercial List]), online: QL (OJ) [hereinafter *Re Royal Oak* O.J. No. 1364]. See also *Anvil Range Mining Corporation* (1998), 7 C.B.R. (4th) 51 (Ont. Gen. Div.) [hereinafter *Anvil*].

8. R. Gordon Marantz, "The Reorganization of a Complex Corporate Entity: The Bramalea Story" in Jacob S. Ziegel & David E. Baird, eds., *Case Studies in Recent Canadian Insolvency Reorganizations: In Honour of the Honourable Lloyd W. Houlden* (Scarborough: Carswell, 1997) 1 at 16.

9. *Supra* note 1, s. 11.7(1). *Re Starcom International Optics Corp.* (1998), 3 C.B.R. (4th) 177 (B.C. S.C.) [hereinafter *Re Starcom*]. *Re United Used Auto* (B.C. C.A.), *supra* note 3 at paras. 13-14.

having access to the company's records and property to the extent necessary to assess the company's financial affairs. The monitor files reports on the state of the company's business and financial affairs, advises the court of any material adverse change in projected cash flow or financial circumstances, advises creditors of the filing of the report, and carries out any additional functions that the court may direct.[10] The monitor, as an officer of the court, ensures that the debtor corporation does nothing that would deplete the resources available to creditors.

The statute is silent on the question of payment of the monitor's fees and disbursements. However, the courts have frequently ordered that payment of reasonable expenses and fees of the monitor, including legal fees, should rank as a first priority charge against the assets of the debtor corporation. The rationale is that the activities of the monitor are for the benefit of all creditors and thus the monitor should be paid prior to any distribution to creditors. The courts have therefore invoked their inherent jurisdiction to create a first charge for fees charged by the monitor.[11] Moreover, the courts have held that it is unlikely that any party would agree to act as a monitor in insolvency proceeding unless there was some assurance of payment.[12]

Another aspect of this type of DIP financing is payment of legal fees and disbursements of the debtor corporation during the *CCAA* process. This has also been granted as a first charge on the assets, either as part of the DIP financing for continued operations or as an administration charge.[13] Some advocates have suggested that this priority is harder to justify during the workout process under the statutory scheme, because, unlike the monitor, counsel for the debtor corporation is not acting in the interests of all the creditors, but rather is acting in the interests of the corporation and indirectly in the interests of the shareholders. However, the debtor corporation needs to have financial and legal advice during the workout process. Clearly, lawyers and restructuring professionals would be unwilling to represent the debtor corporation if there were not some assurance of payment. Therefore, failure to grant the funding may prevent the corporation from working out its affairs.

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10. *Supra* note 1, s. 11.7(3).
11. *Re Westar Mining* (1992), 70 B.C.L.R. (2d) 6 (B.C. S.C.) [hereinafter *Westar Mining*]; *Canadian Asbestos Services* v. *Bank of Montreal* (1992), 16 C.B.R. (3d) 114 (Ont. Gen. Div.) at para. 29 [hereinafter *Canadian Asbestos*].
12. *Re United Used Auto* (B.C. C.A.), *supra* note 3.
13. See the discussion in *Re United Used Auto*, Part IV of this article, below.

The rationale used by the courts for exercising their jurisdiction to grant a priority charge is that it is in the interests of all creditors and the public interest, and thus for the benefit of all those with investments in the corporation, and not only for the shareholders' benefit. Given that the courts have held that as a corporation approaches insolvency the fiduciary obligations of directors and officers require consideration of the interests of creditors,[14] arguably the debtor could establish the need for priority payment of its professionals because they are acting in the interests of creditors as well as shareholders in the *CCAA* process. If there are not benefits to stakeholders in the restructuring exercise, then the workout application should be terminated, as opposed to preventing the debtor corporation from obtaining professional legal assistance. The counter-argument is that creditors are already represented in the process and that shareholders wishing to protect their interest should be prepared to fund the legal costs of doing so. Moreover, there is also a difference between the courts' jurisdiction to make such an order and when it is reasonable to exercise that jurisdiction.

Very recently there have also been cases of representative counsel being appointed to represent employees and retirees of the debtor corporation. Payment for such counsel has also in the rare case been ordered to be paid as a priority administrative charge. For example, in the Eaton's case there were over 10,000 employees not represented by a bargaining agent and there were serious issues of access to justice in terms of the ability of employees and retirees to participate in the workout process. The court ordered that the legal fees for the representative employee and representative legal counsel were to be paid as a priority charge.[15] This was uncontested by the creditors or the debtor because the parties understood that this was an efficient means of considering the interests of these stakeholders, reducing transaction costs considerably.

Thus while the issues tend to be described as "DIP financing" issues, they actually touch on all of these priority charges, where the *CCAA* is silent on the granting of such charges. Geoffrey Morawetz points out that there are essentially three types of DIP financing charges, raising different considerations. First, and now rarely the case, is where the court grants financing but there are no secured creditors and thus those interests are not compromised.[16] Second, is where the value of the assets of the debtor

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14. *Re Sidaplex Plastic Suppliers* v. *Elta Group* (1998), 40 O.R. (3d) 563 (C.A.).
15. *Re T. Eaton Company* (1999), 12 C.B.R. 130 (Ont. Sup. Ct. [Commercial List]).
16. Geoffrey Morawetz, (Remarks to CBAO Forum on DIP Financing, 9 June 1999). See for example, *Re Sammi Atlas Inc.* (1998), 3 C.B.R. (4th) 171 (Ont. Gen. Div. [Commercial List]), where 1400 unsecured creditors held $400 million in debt. Interview with Morawetz (1 April 1999).

corporation exceed secured liability, and thus the granting of DIP financing does not prejudice secured creditors. Morawetz questions, however, why such financing therefore does not simply fall in priority after the claims of those pre-existing secured creditors.[17] The third situation, and most troubling for secured creditors, is where the value of the assets is less than the amount of pre-existing secured credit and thus senior creditors are compromised when the court order sanctions priority DIP financing.[18] Michael Rotsztain points out, however, that where there is insufficient equity in the debtor corporation's assets, a DIP lender is unlikely to advance funds without the court granting a priority over existing secured creditors.[19]

Thus, depending on which category the debtor corporation falls within, the granting of DIP financing may be more or less controversial for secured creditors. DIP financing often allows a corporation to keep operating in order to retain value while trying to negotiate a workout with creditors. For stakeholders such as workers or local governments, it may also result in preservation of their human capital or other economic investments, at least for the period that a possible restructuring plan is being formulated. Moreover, approval of DIP financing to "keep the lights on" may also assist local suppliers in terms of their investments in the firm. Since they can demand cash in exchange for any new supplies, the DIP financing prevents further risk and may ultimately preserve their interests by allowing them to recover the cost of supplies provided to the corporation before the insolvency.

II. *Situating the DIP Financing Debate: Two Statutes, Two Objectives*

The argument that the court has no jurisdiction under the CCAA to order priority financing either to carry on operations or pay for the fees and disbursements of the monitor is premised largely on the notion that the granting of such charges interferes with the priority of claims set out in the *BIA*. This argument deserves consideration, but it must first be situated in the objectives and language of the two statutes.

1. *The BIA as a Comprehensive Code*

The scheme under the *BIA* is to ensure the equitable distribution of a bankrupt debtor's assets among creditors. It is a debt collection regime that allows diverse claims to be sorted out in accordance with a scheme

17. Remarks to CBAO Forum, *ibid.*

18. *Ibid.* See also *Canadian Asbestos*, *supra* note 11 at 122. In a number of cases, secured creditors have consented or acquiesced. See for example *Willann Investments* v. *Bank of America Canada*, [1991] O.J. No. 721 (Ont. Gen. Div.), online: QL (OJ).

19. Rotsztain, *supra* note 2 at 283.

of preferences and priorities at the point of bankruptcy.[20] The *BIA* addresses both commercial and individual bankruptcy and is a highly codified and comprehensive statute dealing with the enforcement of claims and the discharge of honest but unfortunate debtors.[21] When a corporation becomes insolvent, creditors can move to enforce their claims through private or statutory remedies. At the point of bankruptcy, the *BIA* sets out a detailed scheme of distribution of property of the bankrupt, and the role of court-appointed officers in this regime.

The *BIA* also includes provisions for smaller companies and individuals to work out a proposal for compromise of claims or restructuring which will garner the support of creditors.[22] This is also highly codified, with fixed stay periods during which creditors cannot move to enforce their claims without permission of the court.[23] A proposal must be made to all unsecured creditors, however it need not be made to all secured creditors. Section 50(1.3) of the *BIA* specifies that where a proposal is made to secured creditors it must be made to all the secured creditors within a particular class. There are statutory terms that must be included in a proposal and the *BIA* is highly codified in terms of priorities of payment that must be contained in the proposal. Given the rigid codification of the *BIA*, there is some question as to whether there is any jurisdiction for a court to grant interim financing during the proposal process. Although arguably this could be done through the appointment of an interim receiver, there does not appear to be any case law on this point. Under the *BIA* proposal provisions, if a debtor corporation fails to achieve creditor approval within the specified time frame, the debtor is automatically bankrupt and the trustee in bankruptcy will liquidate the assets and distribute the value to claimants as per the priority set out in the statute. Thus the objectives of the *BIA* in terms of companies are the orderly realization of the value of assets on bankruptcy, with provision for debtor companies to make a proposal to their creditors to reorganize or compromise claims.[24]

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20. *Husky Oil Operations* v. *M.N.R.*, [1995] 3 S.C.R. 453 at para. 7.
21. This article discusses corporate insolvency. Individual bankruptcy is beyond the scope of this paper.
22. *BIA*, *supra* note 2. Part III addresses commercial proposals.
23. The initial stay is 30 days and does not require court approval. In exercising its discretion to extend the stay, the *BIA* specifies that it cannot be extended beyond six months. *Ibid.*, s. 50.4.
24. The *BIA* also specifies that the court shall not approve the proposal where the assets of the corporation are not equal in value to 50% of the value of unsecured liability, although the court may specify a lower percentage if it is satisfied that the debtor did not cause the deficiency. *Ibid.*, s. 59.

Canada's insolvency and bankruptcy regime has traditionally been viewed as a secured creditor-friendly regime in that the legislative history has been one of protecting senior creditors' claims, subject to some statutory preferences. There is a statutory hierarchy of priorities for the registering and enforcement of claims. The policy reasons for this are to facilitate the availability of credit for debtor corporations and to allow for certainty in the assessment of risk in lending decisions.

2. *The CCAA and its Objective of Facilitating Arrangements or Compromises with Creditors*

The *CCAA* is a companion statute to the *BIA*, aimed solely at providing a scheme for restructuring of insolvent corporations.[25] The *CCAA* has enjoyed a renaissance in the past fifteen years.[26] As with the *BIA*, restructuring under the *CCAA* can include amending terms of existing debt (such as rescheduling principal repayment), extending maturity dates, altering interest rates or forgoing a portion of the interest or principal owed by the debtor corporation. It also allows the corporation to restructure in such a way as to allow parties to participate, based on some sort of proportional basis, in the value generated by the company as a result of the reorganization and going concern value generated from it.[27] An application for restructuring under the *CCAA* is restricted to corporations with at least $5 million in debt and thus it is aimed at large companies, complex debt situations, and cases in which there are diverse claimants.[28]

While the *BIA* is a comprehensive statute with more than 300 provisions, forms and schedules, the *CCAA* is a short statute with only 22 provisions. Where the *BIA* is a complete code covering realization of claims on bankruptcy, the procedural framework of the *CCAA* has been developed through judicial oversight. The courts have held that its design and efficacy is that of a flexible instrument for the restructuring of insolvent companies.[29]

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25. *Supra* note 1.
26. It was enacted in 1933, but rarely used for fifty years. For an historical context, see *supra* note 5.
27. Stanley Edwards, "Reorganizations under the *Companies' Creditors Arrangement Act*" (1947) 25 Can. Bar Rev. 587 at 596-97.
28. The minimum requirement of $5 million in debt was an amendment to the *CCAA* in 1997. *Supra* note 1, s. 3(1). However, larger companies can elect to proceed through the proposal provisions of the *BIA* instead.
29. *Re Dylex Ltd.* (1995), 31 C.B.R. (3d) 106 at 111 (Ont. Gen. Div. [Commercial List]), Farley J. [hereinafter *Re Dylex*]; *Canadian Red Cross Society*, (1998), 5 C.B.R. (4th) 299 at 315 (Ont. Gen. Div. [Commercial List]), Blair J. [hereinafter *Canadian Red Cross*].

The *CCAA* is aimed at creating a court-supervised process whereby a debtor corporation is permitted to attempt to reach a plan of arrangement or compromise under which the corporation can continue its operations to the benefit of both creditors and the debtor corporation, and thus avoid receivership or bankruptcy.[30] The court determines whether it should grant the initial stay and whether to extend it, defines classes of creditors for purposes of voting on the proposed plan, and addresses a variety of other matters during the *CCAA* process. For example, the monitor was a function created by the courts under the *CCAA* to act in the interests of all creditors.[31] It was only with the statutory amendments in 1997 that for the first time the role of monitor was expressly addressed in the legislation and made mandatory.[32] The role was created to assist the court, facilitate the process, and monitor the debtor corporation on behalf of the creditors to ensure that it did not do anything that would unnecessarily deplete its assets. While the *CCAA* is a flexible instrument for restructuring, it does have its limits. If a proposed restructuring plan fails to garner sufficient support from the creditors and the court, then the plan will fail. While bankruptcy is not automatic, it is likely that the debtor corporation will be liquidated either through a receivership and sale of assets under provincial legislation or by a trustee in bankruptcy pursuant to the provisions of the *BIA*.

Thus the two statutes have different objectives and different schemes for achieving the aims of the legislation. They are complementary in that together they provide a comprehensive regime for dealing with insolvency and bankruptcy of corporations, however their express objectives differ. In part, this is because the statutes address different points in time in the insolvency process.

The *CCAA*'s lack of statutorily prescribed rules means that parties can fashion their own restructuring process to best suit their particular needs, subject to court approval. The courts have often specified that the purpose of the statutory regime set out in the *CCAA* is to facilitate compromises

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30. Secured creditor is defined in the *CCAA* as 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 a bond secured by any of these whether or not the holder or beneficiary resides in Canada, and any trustee under any trust deed or instrument securing any such bonds. Unsecured creditor is defined in the *CCAA* as any creditor of the company that is not a secured creditor, and a trustee for the holders of any unsecured bonds issued under a trust deed or other such instrument. The trustee is an unsecured creditor for purposes of the *Act* except that the trustee does not have the right to vote at a creditors' meeting in respect of the bonds. *Supra* note 1, s. 2; L.W. Houlden & G. B. Morawetz, *Bankruptcy and Insolvency Law of Canada,* 3d ed. (Toronto: Carswell, 1998).

31. *Re Northland Properties* (1988), 69 C.B.R. 266 (B.C. S.C.) at 277.

32. *Supra* note 1, s. 11.7.

and arrangements among companies and their creditors with the objective of allowing the corporation to continue in business.[33] The *CCAA* provides a structured environment for the negotiation of compromises among a debtor corporation and its creditors for the benefit of all.[34] The courts have held that the workout process is for the benefit of secured creditors, but also suppliers, customers and employees, and thus the court will not consider the interests of secured creditors alone.[35] While the *CCAA* does not have an express purpose clause, the courts have been consistent in their findings regarding both the debt collection and rehabilitative nature of the statute. Since there have been two major amendments to the statute in the 1990s without any legislative provisions enacted to counter this interpretation, one can infer that the goals articulated by the court are consistent with public policy.

The underlying premise of the *CCAA* is that it is better for the corporation and its shareholders, employees and other creditors to have the company operating in a way that allows it to meet its obligations, rather than creditors being only able to receive discounted payment at liquidation or sale value. The statute has been described as remedial and the courts have consistently held that it should be interpreted in a fair, large and liberal manner, with the court considering the equities in each case.[36] In deciding whether to exercise its discretion to approve a plan of arrangement or compromise, the court will ensure that the plan has received the requisite approval by creditors pursuant to the requirements of the *CCAA*, and that it is fair and reasonable in the circumstances.[37] Feasibility of the plan, evidenced by the amount of creditor support, is a key factor in the courts' consideration of whether to order a meeting of creditors to vote on a proposed plan.[38] The *CCAA* expressly prohibits parties from contracting out of the provisions of the statute.[39]

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33. *Re Lehndorff General Partner Ltd.* (1993), 17 C.B.R. (3d) 24 at 31 (Ont. Gen. Div. [Commercial List]), Farley J. [hereinafter *Re Lehndorff*]; *References Re CCAA*, [1934] S.C.R. 659 at 661; *Quintette Coal* v. *Nippon Steel Corp.* (1990), 2 C.B.R. (3d) 303 (B.C. C.A.), aff'g (1990) 2 C.B.R. (3d) 291 (B.C. S.C.), leave to appeal to S.C.C. refused (1991), 7 C.B.R. (3d) 164 (S.C.C.); *Hongkong Bank of Canada* v. *Chef Ready Foods* (1990), 4 C.B.R. (3d) 311 (B.C. C.A.) [hereinafter *Hong Kong Bank*].

34. *Elan Corporation* v. *Comiskey* (1990), 1 O.R. (3d) 289 (C.A.) [hereinafter *Elan Corporation*]; *Norcen Energy Resources* v. *Oakwood Petroleums* (1988), 72 C.B.R. (N.S.) 20 (Alta. Q.B.), Forsyth J..

35. *Re Philip Services Corp.* (1999), 13 C.B.R. 159 at paras. 21-22 (Ont. Sup. Ct. [Commercial List]), Blair J.; *Canadian Asbestos, supra* note 11 at para. 23.

36. *Elan Corporation, supra* note 34; *Algoma Steel Corporation* v. *Royal Bank of Canada* (1992), 11 C.B.R. (3d) 1 (Ont. Gen. Div. [Commercial List]), Farley J..

37. *Re Northland Properties* (1988), 73 C.B.R. (N.S.) 175 at 182 (B.C. S.C.) aff'd 73 C.B.R. (N.S.) 195, 34 B.C.L.R. (2d) 122 (C.A.).

38. Edwards, *supra* note 27 at 594-5.

39. *Supra* note 1, s. 8; *Hong Kong Bank, supra* note 33 at 315-16.

Thus creditors ultimately control the outcome of the process in that the majority of creditors representing two-thirds of the value of credit in each class must support any proposed workout before the court will sanction a plan.[40] This context is extremely important to understanding the DIP financing debate, as it is essential to remember that ultimately creditors control the approval process and the hierarchy of creditors' claims prevails in the realization of assets if the debtor corporation cannot devise a plan acceptable to creditors. Whatever compromise of secured creditors' claims occurs as the result of DIP financing, it is generally only a relatively small dollar value of the overall debt, and secured creditors' rights to enforce are stayed only for a brief period. Both the stay and the provision of DIP financing balance creditors' rights to enforce with an opportunity for shareholders and their agents to devise acceptable viable business plans. Those who question the DIP financing orders complain that this balancing process is absent in such decisions because creditors' approval is not required.

Either the debtor corporation or a creditor can make the initial application for a stay or propose a plan of compromise or arrangement.[41] The purpose of a stay order under proceedings pursuant to the *CCAA* is to maintain the *status quo* for a specified limited period of time so that a proposed plan can be negotiated with creditors.[42] If the *CCAA* application is filed for purposes of impeding enforcement of senior creditors' rights, the application will be dismissed.[43] If a large number of secured creditors holding considerable value are opposed to development of a plan, the courts will usually dismiss the application after the initial or first extension of stay.[44]

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40. The 1997 amendments brought the approval percentages required in line with the *BIA*. *CCAA, ibid.*, s. 6.

41. For example, in *Re Cadillac Fairview* (1995), 30 C.B.R. (3d) 17 (Ont. Gen. Div. [Commercial List]), it was Whitehall Street Real Estate Ltd. Partnership, a U.S. "vulture" fund that made the *CCAA* application. Barry I. Goldberg, "A Guide to Enforcing Security in Ontario", (Toronto: Canadian Bar Association - Ontario, continuing Legal Education, 1998) 1 at 48, on file with author.

42. *Re Northland Properties* (1988), 73 C.B.R. (N.S.) 146 (B.C. S.C.); *Sairex GmbH* v. *Prudential Steel* (1991), 8 C.B.R. (3d) 62 (Ont. Gen. Div. [Commercial List]). Unlike the *BIA*, the stay is not automatically effected against the directors, but the statute provides for it and this is routinely set out in the initial order. The same exceptions apply as are set out in the *BIA*. For a discussion of the meaning of *status quo*, see the discussion at Part IV, below.

43. F.J. Newbould and Geoffrey Morawetz, "Developments and Trends in *CCAA* Restructurings" (Canadian Bar Association and The Insolvency Institute of Canada, 1991) at 12.

44. G. B. Morawetz, "Emerging Trends in *CCAA* restructurings" (Toronto: The Insolvency Institute of Canada, 1990) at 35.

The stay period allows insolvent corporations to carry on business in a manner that allows time to undertake discussions with creditors, to attract outside investment or refinancing, and to prepare and seek approval from creditors, and ultimately the court, of a proposed plan of compromise or arrangement.[45] The initial stay is for 30 days, and the granting of any additional stay of proceedings will be based on the court's assessment of whether the debtor company has acted and continues to act in good faith and with due diligence, and whether circumstances exist that make the extension appropriate.[46] In particular, the court will assess whether a company has worked diligently towards the development of a plan.[47] While approval of the creditors is not a prerequisite for extension of a stay, the courts will consider the interests of all stakeholders.[48] Unlike the *BIA*, under the *CCAA* extensions of the stay are not limited to fixed periods or a fixed maximum, although the courts have made it clear that they expect an expeditious process.

Thus the stay provision under the *CCAA* provides the debtor corporation with a brief period to negotiate with creditors who have both converging and diverging interests, and accordingly enhances the opportunity to achieve broad support among diverse interests for the proposed plan of arrangement or compromise. In this sense, the lack of codified requirements under the *CCAA* gives the parties and the court the flexibility to craft constructive and timely workout plans to preserve the business where it is potentially viable.[49] The success of the *CCAA* as a restructuring tool has been the willingness of the courts to interpret the statute in a flexible and purposive manner.[50] The courts have held that because of the remedial nature of the legislation, the judiciary will exercise its jurisdiction and discretion to give effect to the public policy objectives of the statute where the express language of the provisions is incomplete.[51] This

45. The 1997 amendments also allowed for the compromise of claims against directors in their capacity as directors of the corporation.

46. *Supra* note 1, s. 11(6); *Re Starcom, supra* note 9.

47. *Re Downtown Lumber* (1996), 39 C.B.R. (3d) 41 (N.B. C.A.).

48. *Re Starcom, supra* note 9; *Taché Construction* v. *Banque Lloyds du Canada* (1990), 5 C.B.R. (3d) 151 (Que. Sup. Ct.).

49. Sean F. Dunphy, "When No Means Yes: The Ball Packaging Restructuring", *supra* note 8, 255 at 274.

50. The Hon. David F. Tysoe, "Quintette Coal - The Story of its Reorganization", *supra* note 8, 377 at 396.

51. *Re Lehndorff, supra* note 33 at 31; *Re Dylex, supra* note 29 at 110; *Olympia and York Developments* (1993), 20 C.B.R. (3d) 165 at 168 (Ont. Gen. Div.); *Re NsC Diesel Power* (1990), 79 C.B.R. (N.S.) 1 (N.S. S.C. (T.D.)). *Westar Mining, supra* note 11; ; *Interpretation Act*, R.S.C. 1985, c. I-21, s.12.

includes endorsement of a survival program of the debtor corporation until it can develop and present a plan of arrangement.[52]

However, the lack of legislative direction on the question of priority or DIP financing during the stay period has resulted in disputes about the scope and process of granting that funding during the workout period. The courts have held that the statutory restructuring scheme contemplates that the rights and remedies of various creditors might be temporarily sacrificed in an effort to serve a "greater good" by delaying the collection of debt and allowing a plan of arrangement to proceed.[53]

III. *The Granting of Priority Financing: The Courts' Rationale*

The courts have interpreted their equitable or inherent jurisdiction as including the ability to order DIP financing to allow corporations to continue operating during the stay period under the *CCAA*.[54] They have also determined that they have jurisdiction to order administration charges to facilitate the objectives of the *CCAA*, specifically a monitor's legal and professional fees to carry out its statutory duties and to assist in the negotiation of a plan of arrangement or compromise. Generally courts have determined that the jurisdiction for making both types of orders rests on a court's inherent jurisdiction to make orders that advance the objectives of the *CCAA*.

The granting of DIP financing can result in a compromise of creditors' traditional rights.[55] Prior to the development of DIP financing, debtor corporations required the financial support of operating lenders to carry on business during the restructuring process.[56] This enhanced accountability because the debtor corporation needed the support of the operating lender to finance operations during the period in which it was attempting to develop a plan. Geoffrey Morawetz has observed that early

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52. *Re Dylex, ibid.* at 110.

53. *Icor Oil & Gas Co.* v. *Canadian Imperial Bank of Commerce* (1989), 102 A.R. 161 at 165 (Q.B.).

54. *Re United Used Auto* (B.C. C.A.), *supra* note 3; *Canadian Asbestos, supra* note 11 at para. 31. The courts also grant DIP financing under *BIA* proposal provisions. A few *CCAA* cases also refer to "GAR" funding, "general, administrative and restructuring" funding. These terms are in part interchangeable, although arguably DIP financing is a more inclusive term because it relates to financing beyond that required to actually restructure. See for example, *Re Olympia & York Developments* (1996), 38 C.B.R. (3d) 309 (Ont. Gen. Div.); *Re Bramalea Inc.* (1 March 1995), Toronto RE5055/95 (Ont. Gen. Div.).

55. See for example: *Re Dylex* (23 January 1995), Toronto B-4/95 (Ont. Gen. Div.), Houlden J. A.; *Re The T. Eaton Company* (27 February 1997), Toronto RE-7483/97 (Ont. Gen. Div.), Houlden J. A.; *Re Skydome Corporation, Skydome Food Services and SAI Subco* (27 November 1998), Toronto 98-CL-3179 (Ont. Gen. Div. [Commercial List]), Blair J..

56. Geoffrey Morawetz, "The Canadian Version of DIP Financing", Houlden and Morawetz On-Line Newsletter (Toronto: Carswell, 1999) at 1.

Canadian cases of DIP financing did not address jurisdictional issues because the financing charge did not jeopardize the pre-insolvency ranking of secured credit or because the financing was obtained with the consent of other secured creditors.[57] It was not until courts began to grant such financing where there was not unanimous consent of secured creditors or where there was some interference in priorities that they were faced with the question of the limits of their inherent jurisdiction to grant such financing. Then issues of jurisdiction, including the tension between federal insolvency legislation and provincial property legislation, became highlighted.[58]

It is helpful to note that there had been criticism that preserving the *status quo* during the stay period required that lenders of operating capital continue lending.[59] To address this, the *CCAA* was amended in 1997 to specify that the effect of a stay order does not require the further advance of money or credit.[60] The amendments also made clear that the stay did not have the effect of prohibiting a party from requiring immediate payment for any goods, services or use of leased or licensed property provided after the order is made.[61] The legislation remained silent, however, on the question of the courts' jurisdiction to grant priority and DIP financing. Given that the courts had been exercising their jurisdiction to grant such financing prior to the amendments, arguably one could conclude that Parliament was not discontent with the current exercise of the courts' jurisdiction to grant such financing. The British Columbia Court of Appeal in *Re United Used Auto* noted this in upholding the first charge for the monitor's fees and disbursements, finding that the only reasonable conclusion was the legislators were aware of the courts' general jurisdiction and assumed that jurisdiction remained available except as inconsistent with the *CCAA*.[62]

1. *The Exercise of Inherent or Equitable Jurisdiction*

Courts have in a number of cases granted priority or DIP financing to a debtor corporation to allow it to carry on business pending the development of a plan. They have found authority for granting super-priority of this financing in their inherent jurisdiction, and in their jurisdiction under the

57. *Ibid.* at 2.
58. Morawetz points out that for existing secured creditors that believed they had a first or second registered charge over certain property as set out in provincial legislation, the notion that priority could be altered by the granting of DIP financing was problematic. *Ibid.* at 1.
59. *Ibid.* at 35.
60. *Supra* note 1, s. 11.3.
61. *Ibid.*
62. *Re United Used Auto* (B.C. C.A.), *supra* note 3 at para. 15.

CCAA, the *BIA* and other statutes.[63] Judges have tended to use the terms "inherent jurisdiction" and "equitable jurisdiction" interchangeably. One question is whether these are different notions or merely a distinction without a difference. The language needs to be unpacked. A careful reading of the courts' reasoning illustrates that they rely on their inherent jurisdiction to deal with issues of fairness of the process, and based on principles of equity to grant substantive extraordinary remedies so as to give effect to the aims of the legislation.

"Inherent jurisdiction" has been defined as the exercise of those powers that are reasonably necessary for the administration of justice.[64] Canadian provincial superior courts are courts of inherent jurisdiction.[65] Inherent jurisdiction is a "residual source of powers, which the court may draw upon as necessary whenever it is just and equitable to do so, in particular, to ensure the observance of the due process of law, to prevent improper vexation or oppression, to do justice between the parties and to secure a fair trial between them".[66] While *Halsbury's* has characterized inherent jurisdiction as procedural rather than substantive law, the Supreme Court of Canada has not followed this reasoning, and has accorded it both a substantive and procedural meaning.[67]

The Supreme Court of Canada has held that the notions of inherent jurisdiction and statutory jurisdiction are cumulative, not mutually exclusive.[68] A court may exercise its inherent jurisdiction in respect of matters regulated by statute as long as it does so without contravening or conflicting with a statutory provision.[69] The Supreme Court has held that, notwithstanding the comprehensiveness of statutory provisions, courts retain a residual discretionary power to grant relief, and only an explicit ouster of jurisdiction should be allowed to deny jurisdiction to a superior court.[70] The Supreme Court held that there are two prerequisites to the exercise of discretion, first that the subject matter is within the jurisdiction of the court, and second that the court has taken into consideration all the

63. *Re Skydome Corporation, supra* note 55.

64. *Black's Law Dictionary*, 5th ed., *s.v.* "inherent powers of a court".

65. *C.H.R.C.* v. *Canadian Liberty Net*, [1998] 1 S.C.R. 626 at para. 35.

66. Mr. Justice Farley, citing *Halsbury's Laws of England*, vol. 37, 4th ed. (London: Butterworths, 1982) at para. 14, in *Re Royal Oak Mines* (1999) 7 C.B.R. (4th) 293 at para. 4 (Ont. Gen. Div. [Commercial List]), Farley J. [hereinafter *Royal Oak Mines*].

67. *Halsbury's, ibid.* at para. 14. *Société des Acadiens du Nouveau-Brunswick* v. *Association of Parents for Fairness in Education*, [1986] 1 S.C.R. 549 at paras. 94 - 95 [hereinafter *Société des Acadiens*].

68. *Société des Acadiens, ibid.*.

69. *Ibid.* at para. 95; see also *Baxter Student Housing* v. *College Housing Co-operative*, [1976] 2 S.C.R. 475 at 480 [hereinafter *Baxter*].

70. *C.H.R.C., supra* note 65 at paras. 10, 32.

relevant factors.[71] The Supreme Court has emphasized that there is a distinction between the jurisdiction of a court to exercise its power and the appropriateness of exercising its discretion in a particular circumstance.[72]

In the context of priority charges in the insolvency context, the courts have held that there is an inherent jurisdiction to subordinate existing security, but that it should only be exercised in extraordinary circumstances.[73] In one case a court noted that the granting of DIP financing did not change priorities or jeopardize security, rather it was an acknowledgement that DIP lenders should be paid in priority because the financing was for the benefit of all creditors, secured and unsecured.[74] There, it was anticipated that there would be greater assets available for all creditors as the result of completion of contracts and receipt of receivables.[75]

The exercise of inherent jurisdiction has both a procedural and a substantive component, although the line between these is frequently overlapping or blurred. The courts have the jurisdiction to control their process, aimed at ensuring procedural fairness and a timely resolution of applications under the *CCAA*. The granting of priority financing may well be an exercise of inherent jurisdiction in the sense that the *CCAA* process will only be fair if the debtor corporation is afforded an opportunity to attempt to work out its affairs as a going concern business before senior creditors move to enforce their claims through liquidation. Granting a stay when the corporation cannot continue to operate without financing is a mere postponement of liquidation. In that sense, it is an exercise of discretion to both control and bring an element of fairness to the legislated process, having regard to prejudice to the parties and the need for timeliness.

Courts have also discussed this notion of inherent jurisdiction on the basis of an equitable jurisdiction. Waddams *et al.* observe that modern substantive common law is derived almost entirely from equity, or that it frequently incorporates equitable principles.[76] The key principles are that equitable remedies are only available at the court's discretion, that the interests of the plaintiff must be weighed in the balance of all interests involved in the proceeding, that the courts will consider the relative prejudice to parties in ordering equitable remedies, and that the courts are

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71. *Société des Acadiens, supra* note 67 at para. 123.
72. *C.H.R.C., supra* note 65 at paras. 13-14.
73. *Re United Used Auto & Truck Parts* (1999), 12 C.B.R. 144 at para 24 (B.C. S.C.) [hereinafter *Re United Used Auto* (B.C. S.C.)]. See also *Royal Oak Mines, supra* note 66.
74. *Canadian Asbestos, supra* note 11 at paras. 26-27.
75. *Ibid.*
76. Stephen Waddams *et al.*, *Remedies Cases and Materials*, (Toronto: Emond Montgomery, 1988) at 517.

concerned with the efficacy and efficiency of their own process.[77] Courts have recognized that equitable remedies are often intrusive and burdensome, and they will balance the specific relief to one party against the burden of that form of relief to other parties.[78] Judges will exercise their equitable jurisdiction to give effect to the law and fill gaps where the legislation is not specific.

In a similar but also distinguishable context, that of appointment of receivers and priority charges, the Supreme Court of Canada has held that the origins of a receiver's jurisdiction are located in the equity jurisdiction of the Court of Chancery and that, while jurisdiction cannot be exercised contrary to statute, nothing precludes its exercise to supplement a statute and effect its objectives.[79] In determining priority for payment of receivers, the courts have set guidelines as part of the exercise of their jurisdiction.[80] In such cases, courts consider both the objectives of the legislation and the role of the receiver, which is to preserve and realize on the assets of the corporation on behalf of the creditors. The situations are analogous, in that the roles of both receivers and monitors are grounded in equity. However, the monitor serves a broader mandate than does a receiver, in that it is assisting in the protection of value of assets while also facilitating the development of a plan that will benefit all interested stakeholders. In the *CCAA* context, therefore, the courts must consider the legislative objectives of facilitating a workout and the role of the monitor in that endeavour, in order to determine when and where to exercise jurisdiction to order a priority charge.

Moreover, practically speaking, while monitors are independent officers of the court, they are also dependent on future appointments as monitors. Given that there are limited numbers of actors in insolvency litigation in Canada, there is also normative pressure on monitors to act fairly and reasonably and to carefully control administration costs.[81]

In many *CCAA* cases, the courts' granting of DIP financing has a substantive purpose: to afford time for the corporation to continue operations while resolving the restructuring plan because of the broader interests at stake if the corporation becomes bankrupt. Canadian courts frequently cite the potential economic consequences for employees, local

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77. *Ibid.* at 521-2.
78. *Ibid.*
79. *Baxter, supra* note 69.
80. See for example, *Braid Builders Supply & Fuel* v. *Genevieve Mortgage Corp.* (1972), 17 C.B.R. 305 (Man. C.A.).
81. This type of observation has been made in the context of nominee directors of corporations, in the sense that they are to act in the best interests of the corporation independent of their nominating shareholders, but at the same time risk having a short career as a nominee director. *820099 Ontario Inc.* v. *Harold Ballard Ltd.* (1991), 3 B.L.R. 123 (Ont. Gen. Div.).

trade suppliers, communities and other unsecured creditors.[82] Thus the granting of DIP financing is an exercise of equitable jurisdiction, equity coming into play when the statutory framework does not address or provide a remedy that redresses some risk or harm.[83] The question is, what should be required of the debtor corporation or creditors seeking the DIP financing in terms of demonstrating the risk of harm and thus the necessity for an equitable remedy of DIP financing? Tysoe J. noted that demonstrating that it would be beneficial is not a sufficient threshold, rather it requires that DIP financing be critical for the business to continue to operate in order for the debtor corporation to successfully restructure its affairs.[84]

With respect to the DIP financing question, the courts have held that equity underpins the courts' *CCAA* jurisdiction. The *CCAA's* objective is broader than just preservation and realization of assets for the benefit of creditors; it is to facilitate plans of arrangement with creditors.[85] The court is concerned with the survival of the debtor corporation long enough to present a plan. The courts have exercised discretion to grant priority payment to the monitor, but other professional fees have been denied where there was no evidence that priority was necessary for continued operations and where cash flow allowed for monthly professional fee payments.[86] The granting of DIP financing has included cases where the security was granted on unencumbered assets of the debtor corporation and thus existing security was not compromised;[87] where the existing secured creditor was not adversely affected by the financing order;[88] where the financing was obtained with the consent of the existing secured creditors, where the money was advanced for the benefit of all creditors;[89] and where the reduction in value of existing creditors' security was not significant in terms of the overall value involved and in terms of the overall economic and financial effects of declining such a request.[90]

In *Re Dylex*, the court found that, in the absence of new priority financing even where there was an opposing secured creditor, the company would not have been able to obtain the inventory for stores nor

82. See for example *Re Skydome, supra* note 55 and *Anvil, supra* note 7.
83. *Re United Used Auto* (B.C. S.C.), *supra* note 73 at para. 29.
84. *Ibid.*
85. *Ibid.* at para. 16.
86. *Re Starcom, supra* note 9 at paras. 48-54.
87. *Westar Mining, supra* note 11; *The T. Eaton Company, supra* note 55.
88. *Re Dylex, supra* note 29; *Re Chef Ready Foods* (1990), 4 C.B.R. (3d) 307 (B.C. S.C.), aff'd, [1991] 2 W.W.R. 136 (B.C.C.A.); *Hong Kong Bank, supra* note 33.
89. *Canadian Asbestos, supra* note 11; supplemental reasons (1993), 13 O.R. (3d) 291 (Gen. Div.).
90. *Re Skydome, supra* note 55 at 5, Blair J..

provide assurances to suppliers to guarantee future production.[91] Houlden J. concluded that granting DIP financing was the only way in which the company could continue in operation to the benefit of 12,000 employees and large numbers of people indirectly affected, such as suppliers and their employees.[92] The court held that while creditors are not compelled to give any additional credit, the creditors' security may be weakened by the court's approval of DIP financing.[93]

In restructuring proceedings, a court will engage in a balancing of prejudices between the parties, and secured creditors may be required to make some sacrifice in order to achieve reasonably anticipated benefits for all stakeholders.[94] The objective of the *CCAA* is broader than preservation and realization of assets for the benefit of creditors; it is to facilitate arrangements and thus protect broad interests in the corporation.[95] Thus limited DIP financing has been granted to allow all stakeholders an opportunity to negotiate a restructuring plan, such financing aimed in part at the public interest in trying to avoid the social and economic consequences of firm failure.[96] At the same time, the courts have recognized that DIP financing can erode the security of creditors and thus the court should make such orders where there is a reasonable prospect of successfully restructuring.[97]

Blair J. of the Ontario Superior Court of Justice, in endorsing an order for DIP financing in *Re Royal Oak Mines,* held that extraordinary relief such as DIP financing with priority status should be granted only in an amount that is reasonably necessary to meet the debtor's urgent needs over the sorting out period. He held that the financing should be enough to "keep the lights on" and enable it to meet appropriate preventive maintenance measures, but that an initial order should approach that objective in a judicious and cautious manner.[98] In *Royal Oak*, the debtor corporation was seeking super-priority financing over all lenders, including some lien claimants. The lien claimants, whom the court noted ranked first in priority, were not given notice of the application.[99] The court was concerned about the quantity of proposed DIP financing on broad terms and without the benefit of interested parties having the opportunity to

91. *Re Dylex, supra* note 29.
92. *Ibid.*
93. *Ibid.*
94. *Re Skydome, supra* note 55 at 5. *Royal Oak Mines, supra* note 66 at para. 5, Farley J..
95. *Re Skydome, ibid.* at para. 28.
96. *Supra* note 5 at 101. See also *Re Skydome, ibid.*
97. *Re Skydome, ibid.* at para. 30.
98. *Re Royal Oak Mines* (1999), 6 C.B.R. (4th) 314 at para. 24 (Ont. Gen. Div. [Commercial List]) [hereinafter *Re Royal Oak Mines*].
99. *Ibid.* at paras. 9-11.

properly review the information and to consider their positions.[100] The court held that financing requests in initial orders should be confined to what is reasonably necessary for the continued operation of the debtor corporation during a brief but realistic period on an urgent basis.[101] This is because the granting of such priority often places encumbrances ahead of pre-existing claims and such changes should not be imported lightly, if at all, into the creditor mix.[102] The court held that affected parties are entitled to a reasonable opportunity to think about their potential impact, and to consider such things as whether or not the *CCAA* approach to the insolvency, rather than a receivership or bankruptcy, is the appropriate one in the circumstances. Parties should be given an opportunity to decide to what extent, if at all, they are prepared to have their positions affected by DIP or super priority financing.[103] The court thus limited the amount of DIP financing that it would sanction in the initial order.

Subsequent to that decision, Farley J., in the same *CCAA* application, held that while the courts have considerable power under both the *CCAA* and their inherent jurisdiction to grant super-priority financing, that jurisdiction is not limitless.[104] Thus, while DIP financing may be granted because it is reasonably anticipated that there are benefits to be derived from any compromise of creditors' claims, there may be statutory provisions that limit the inherent jurisdiction of the court to grant such priority.[105] Here, the court held that the *Builders Lien Act* operated in such a way as to limit the court's jurisdiction to grant a super-priority of DIP financing over the lien claimants.[106]

The issue of DIP financing is currently a hotly debated one, particularly in light of the increase in *CCAA* applications, accompanying applications for DIP financing, and the appearance for the first time of DIP financing specialty lenders.[107] In practice, however, the number of cases in which DIP financing has been opposed are relatively few, or are focused on the amount sought as opposed to the actual exercise of the court's discretion. Moreover, where such financing is objected to, the

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100. *Ibid.* at paras. 12, 21.
101. *Ibid.* at para. 21.
102. *Ibid.* at para. 24.
103. *Ibid.*
104. *Royal Oak Mines, supra* note 66, citing *Baxter, supra* note 69 and *Canada (Minister of Indian Affairs and Northern Development)* v. *Curragh Inc.* (1994), 27 C.B.R. (3d) 148 at 159 (Ont. Gen. Div. [Commercial List]).
105. *Royal Oak Mines, ibid.* at paras. 6-7. The Court expressly declined to import the approach of the U.S. courts under United States bankruptcy legislation.
106. *Ibid.* at para. 7. Mr. Justice Farley held that even if he did have jurisdiction to grant a super-priority over the liens, he would decline to exercise his discretion in this respect on the particular facts of the case. *Builders Lien Act*, R.S.B.C. 1996, c. 41, s. 11.
107. *Supra* note 56 at 1.

courts have required the debtor corporation to come back within a very limited time period to justify continued or additional relief. In such cases, the courts have been rigorous in their assessment of whether the stakeholders, having considered their positions, really believe that there is a possibility of a feasible workout plan.[108]

Alexander Zimmerman has recently argued that it is fundamentally unfair that those with little economic incentive to allow the debtor corporation to restructure should be asked to bear both the risk and cost of super-priority funding that subordinates their position.[109] While this can be true, the question of whether there is any economic incentive in a given case involves an assessment of the liquidation value of the enterprise. In circumstances where secured creditors are likely to receive considerably more in a restructuring than a liquidation, there is some economic incentive to bear both the risk and cost of financing that subordinates their interest, if the economic benefits of that financing outweigh the risks.

IV. *Re United Used Auto: The Claim by Creditors that the Court has no Jurisdiction to Grant Non-Consensual Super-Priority*

The British Columbia Court of Appeal upheld the jurisdiction of the court to order DIP financing in *Re United Used Auto*. The Supreme Court of Canada subsequently granted leave to appeal the B.C. judgment and this would have been the Supreme Court's first consideration of this issue. It would also have settled the matter of jurisdiction to order DIP financing that continues to be hotly contested by secured lenders. However, in March 2001, the parties in *Re United Used Auto* settled the matter. The law thus currently stands that Canadian courts have jurisdiction to grant priority to funding for a reorganization under the *CCAA* ahead of secured creditors without their consent, although challenges to jurisdiction continue to be brought. This part discusses the *Re United Used Auto* case, in order to more fully appreciate the basis on which the courts have determined jurisdiction.

United Used Auto & Truck Parts Ltd. sold car parts, conducted a wrecking business and had engaged in acquiring numerous parcels of real estate over the years. It had been experiencing financial difficulty for more than a decade and financed its losses by heavily mortgaging its

108. *Re Royal Oak* O.J. No. 1364, *supra* note 7.

109. H. A. Zimmerman, "Financing the Debtor in Possession" (Tenth Annual Meeting and Conference of The Insolvency Institute of Canada, November 1999) Carswell, Insolvency Pro at 15.

properties. By the time it was insolvent, the secured debt alone was $24 million and the value of the real estate was $23- $49 million, depending on estimates and whether the land was to be sold *en bloc* or by parcel.[110] Secured creditors had made a series of arrangements, entered forbearance agreements, and then finally moved to enforce their claims through orders *nisi*, expiry of redemption periods, and an Order for Conduct of Sale. It was at the point of sale, an order to which the debtor had consented, that the debtor applied for a stay under the *CCAA*.

At first instance, the application for a stay under the *CCAA* was made on an *ex parte* motion before Tysoe J. of the British Columbia Supreme Court. Tysoe J. granted the stay application, appointed a monitor and ordered all the monitor's reasonable fees and disbursements to be paid in priority to secured charges. He also ordered that the reasonable legal fees of the debtor corporation under the *CCAA* process be paid in priority. The maximum amount of these administration charges was to be $500,000.[111] The monitor was directed to engage in a range of activities to assist the petitioners in the development of a plan, to monitor cash flow and protect the assets.[112] The court declined to consider the question of DIP financing on an *ex parte* motion.

On November 19, 1999 Tysoe J. issued a further judgement in the matter. On notice to creditors, the debtor again sought $1.1 million in DIP financing. Secured creditors moved to set aside the initial order on grounds of inadequate disclosure and allegations of bad faith. The court declined to find either improper disclosure or bad faith, and refused to lift the stay order under the *CCAA*. This was notwithstanding the fact that the court found there was evidence that the debtor had not acted reasonably in the attempts to sell the land over the past two years.[113] The court held that it was not bad faith to bring the *CCAA* application at this time because the debtor was concerned that an *en bloc* sale would mean an end to the operating business.[114] The court allowed the sale to continue, but directed the listing agents to deal with the monitor and the debtor rather than the creditors. The court denied the debtor's request for DIP financing to carry on operations. The court cautioned that in determining a DIP financing request and in balancing the interests involved in a *CCAA* proceeding there should be cogent evidence that the benefit of DIP financing clearly

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110. *Re an Application under the Companies' Creditors Arrangement Act and Re United Used Auto & Truck Parts Ltd.* (8 November 1999) Vancouver, Initial stay order, (B.C. S.C.), Tysoe J.

111. *Ibid.*

112. *Ibid.*

113. *Re United Used Auto* (B.C. S.C.), *supra* note 73 at para. 19, Tysoe J.

114. *Ibid.* at para. 17.

outweighs the potential prejudice to the lenders whose security is being subordinated.[115] It found that it had inherent jurisdiction to order DIP financing, but that this jurisdiction to subordinate secured interests should only be exercised in extraordinary circumstances.[116] It further held that while DIP financing would have been beneficial, it was not satisfied that it was critical to keep the business operating, thus the motion for DIP financing was dismissed.[117]

However, the court affirmed the priority charge for the monitor's fees and disbursements. It held that the monitor was acting on behalf of the court to provide information and monitoring for the benefit of all parties.[118] It directed the monitor to take account of all interests, including debtor, secured and unsecured creditors in proceeding to conduct the sale process and consider offers.[119] The monitor is an officer of the court and has an obligation to act independent of both the debtor and the creditors.[120] The court also granted an order funding the debtor's restructuring legal expenses, included as part of the administration charge similar to cost of the monitor, as a limited substitute for DIP financing.[121] The court noted that payment for restructuring would normally come out of the cash flow, but here there was no cash flow and no DIP financing, thus it was an appropriate case in which to grant a priority charge on the legal fees of the debtor reasonably incurred in connection with the restructuring exercise. The court cautioned however, that should there be a shortfall in recovery for lenders, it would unfair to request the secured creditors to bear all the burden of legal fees for those acting against them, and thus they would not be required to underwrite the expenses of lawyers who act unreasonably or who act on unreasonable instructions to frustrate the recovery of monies owed to creditors.[122] The court reduced the amount originally approved from $500,000 to a maximum of $200,000, pending any further application justifying an increased limit.[123] Thus the priority charges granted amounted to less than 1% of the secured debt.

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115. *Ibid.* at para. 28.
116. *Ibid.* at para. 24.
117. *Ibid.* at paras. 29-30.
118. *Ibid.* at para. 31, relying on *Re Starcom*, *supra* note 9.
119. *Re United Used* Auto (B.C. S.C.), *ibid.* at para. 19.
120. *Ibid.* at para. 20. The Court also noted that creditors were free under the come back clause to seek to have the monitor replaced if it was not performing its obligations under the statute.
121. *Ibid.* at paras. 32-36.
122. *Ibid.* at paras. 34-35.
123. *Ibid.* at para. 36.

The secured creditors appealed on the sole question of the court's jurisdiction to grant priority charges to pay the fees and disbursements of the monitor, and the legal fees of the debtor associated with the restructuring in the absence of secured creditors' consent.[124] The British Columbia Court of Appeal in *Re United Used Auto* affirmed the B.C. Supreme Court decision, confirming the lower court's equitable jurisdiction to order super-priority financing.[125] The Court of Appeal held that the effective achievement of the legislation's objective requires a broad and flexible exercise of jurisdiction to facilitate a restructuring, and the court's equitable jurisdiction permits orders granting super-priority in some circumstances.[126] The court took note of the fact that the debtors had left it "very late in the day to apply for *CCAA* relief" and observed that the secured creditors had failed in their efforts to oppose the stay, but that no appeal was taken from that part of the order.

The court held that once the stay order was granted, the legislation required the appointment of a monitor. It went on to rule that the required duties of the monitor specified in the *CCAA* were extensive and that Parliament knew of the courts' granting priority charges for monitors when it enacted these provisions in 1997. Thus it may be taken to have understood that the court will continue to exercise its jurisdiction. The court contrasted those provisions of the *CCAA* that expressly specify what will not be considered an administration charge.[127] It held that a monitor will need assurance that it will be paid before it will act and this priority charge is the only effective means of securing payment.[128] It found that the administration charges were a substitute for DIP financing, and that where no DIP financing has been granted, which would normally cover the debtor's costs associated with the workout, the court has inherent jurisdiction to exercise its discretion to order such costs to be covered. It further held that granting priority on the restructuring costs, whether separately or as part of DIP financing, rests on the same equitable foundations as monitors' fees.[129]

The Court of Appeal also ruled that it had jurisdiction to grant DIP financing based on equitable principles, but upheld the trial judgment that declined to exercise this discretion on the facts of the case.[130] The court held that this is an extraordinary remedy and that its jurisdiction can be

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124. *Re United Used Auto* (B.C. C.A.), *supra* note 3 at para. 1.
125. *Ibid.* at paras. 30-31.
126. *Ibid.* at para. 12.
127. *Ibid.* at paras. 14-15; see for example *supra* note 1, s. 11.8(1).
128. *Re United Used Auto* (B.C. C.A.), *ibid.* at para. 15.
129. *Ibid.* at paras. 31-35.
130. *Re United Used Auto* (B.C. S.C.), *supra* note 73.

exercised without consent of the secured creditors notwithstanding the fact that the administration charge or DIP financing would rank ahead of their claims.

The creditors sought and received leave to appeal to the Supreme Court of Canada.[131] They argued that the court does not have jurisdiction to grant priority to funding for a *CCAA* reorganization without the consent of secured creditors because it interferes with priorities among secured interests and because there is a need for certainty in secured transactions.[132] They argued that the courts are exercising a broad and undefined jurisdiction that interferes with the property rights set out in the *BIA*. The Supreme Court granted leave. However, in March 2001, the parties settled the matter by agreeing to reduce the monitor's fees, and thus there is no longer an opportunity to have the Supreme Court finally determine the matter. Yet the court's jurisdiction to grant priority financing continues to be challenged in *CCAA* applications. The *Re United Used Auto* case squarely raised the issue of whether the exercise of the court's equitable jurisdiction infringes on the priorities set out in the *BIA* for the enforcement of credit or other statutory property rights under provincial secured transaction legislation.

There are some initial observations to be made. First, there is no evidence that the courts are exercising a "broad and undefined jurisdiction" to order priority financing. As Part VI illustrates, there are principles that the courts have consistently applied to determine whether the discretion should be exercised. In *Re United Used Auto*, the court found it had jurisdiction, held that this should be exercised as an extraordinary remedy, declined to make an order for DIP financing, and reduced the amount given in other priority charges to less than 1% of the secured debt.

Second, the notion that the *CCAA* stay preserves the *status quo* does not mean that a court lacks jurisdiction to order priority financing. The courts have held that in the stay context of *CCAA* proceedings, *status quo* does not mean freezing the pre-stay debt status of each creditor. Rather, preserving the *status quo* means preserving the interests of all creditors (secured and unsecured) and the interests of suppliers, consumers, employees, landlords, investors and the public, and in that context the debtor is allowed to continue to operate during a brief period in which a plan can be devised and negotiated with creditors.[133] The courts have a supervisory role to preserve the *status quo* in the sense that creditors are

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131. *Re United Used Auto* (S.C.C.), *supra* note 3.
132. *Ibid.*, motion record of Rashid Aziz, application for leave to appeal, argument at para. 26.
133. *Re Starcom*, *supra* note 9 at paras. 17, 19; *Re Alberta Pacific Terminals* (1991), 8 C.B.R. (3d) 99 at para. 23 (B.C. S.C.), Huddart J..

not allowed to maneuver to impair the financial situation of the corporation during the *CCAA* process.[134] The courts are to facilitate the process to the point where a plan is approved or it is evident that the workout process is doomed.[135]

In considering whether there is a conflict between the *BIA* and the *CCAA* on the issue of DIP financing, both are federal statutes and thus there are no paramountcy issues. The *CCAA* and *BIA* are complementary statutes with different objectives and aimed at different aspects of the insolvent corporation. The *BIA* does permit workouts for consumers and businesses, but is largely aimed at the orderly distribution of the value of assets to creditors on bankruptcy. There has, however, been some fluctuation in this respect in recent years and the proposal provisions have occasionally been used as a key tool of the *BIA*. Aside from the proposal provisions of the *BIA*, which are similar but more codified than those in the *CCAA*, the scheme of the *BIA* comes into effect at the point of bankruptcy.[136] In contrast, the *CCAA* is aimed at the period in which the corporation is insolvent, and has the objective of facilitating arrangements between debtor corporations and creditors. The *CCAA* co-exists with the *BIA* in Canada's insolvency and bankruptcy regime, and notwithstanding that the courts have adopted a purposive interpretation of the *CCAA* in the past 15 years, legislators did not see the necessity of dismantling it during the major amendments to both statutes in 1997. The *CCAA* is a statute with extremely time-limited remedies.[137] The courts have declined to grant initial stays where it is evident that there is no possibility of a successful workout. When a stay is granted a court will facilitate an expeditious process, and failing agreement to a plan, creditors can move to realize their claims under the *BIA*. Thus, creditors' remedies are only stayed for very limited periods.

One authority relied on by creditors in *Re United Used Auto* is the *Sparrow Electric* decision of the Supreme Court of Canada.[138] The judgment offers important insights into how to approach issues of interpretation. The Supreme Court in *Sparrow Electric* held that it must be sensitive to differing legislative objectives when interpreting statutory

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134. *Re Starcom, ibid.* at para. 19.

135. *Ibid.*

136. It is helpful to note that the proposal provisions under the *BIA*, like the arrangement provisions under the *CCAA*, do not conflict with the provisions of the *BIA* regarding the orderly distribution of assets because they involve a time period prior, specifically, the stay period during which the corporation is attempting to work out its affairs to avoid bankruptcy.

137. The initial stay is 30 days, with a fairly high threshold established by the courts for any extension on that stay.

138. *Royal Bank of Canada* v. *Sparrow Electric Corporation*, [1997] 1 S.C.R. 411 [hereinafter *Sparrow Electric*].

language that appears to conflict.[139] The court held that at the point that a receiver is appointed to enforce security under the *BIA*, in a priority competition between a perfected general security agreement (GSA) and a deemed trust under the *Income Tax Act*, the GSA prevailed at the point of bankruptcy because the property vested in the creditor at the time that the agreement was concluded.[140] The court ruled that when a debtor fails to set aside remittances, the crown's claim becomes one of a beneficiary under a deemed trust, not a real trust because the value of the remittances owed cannot be identified separate from the rest of the debtor's assets.[141] Thus at the point of bankruptcy, the court has held that it will defer to the priorities set out in the *BIA*, and that this interpretation of the *ITA* was consistent with and supported the scheme of distribution under the *BIA*.

Applying this type of reasoning previously used by the Supreme Court of Canada to the *CCAA*, at the point of bankruptcy the scheme of the *BIA* takes over and a court will no longer be able to exercise its jurisdiction to order priority charges. Thus the *CCAA* and the *BIA* are involved sequentially and there is no conflict. The *CCAA* proceeding terminates and the *BIA* process may or may not be utilized, depending on whether there is a private liquidation, receivership proceedings under provincial legislation or bankruptcy proceedings under the *BIA*. The court may validly affect priority in a non-bankruptcy situation. The exercise of its inherent jurisdiction does not conflict with the language of either the *CCAA* or the *BIA*. The Supreme Court of Canada has previously indicated that an exercise of inherent jurisdiction must not be in conflict with statutory provisions. Here, there is no conflict; the *BIA* does not address priority in the stay period under the *CCAA* nor is it operational during *CCAA* proceedings, and thus, jurisdiction is not ousted by that statute. The exercise of the court's discretion under the *CCAA* must take into account the circumstances of the debtor's insolvency, the objectives of the *CCAA*, the relative prejudice to granting or not granting financing to secured lenders, and the interests of unsecured lenders, employees, consumers, tort claimants and the public. The objective of the *CCAA* is broader than the preservation of secured credit, and this must be considered when reconciling the provisions of the *CCAA* and the *BIA*.

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139. *Ibid.*

140. *Ibid.* Subsequent to this decision, the *Income Tax Act* was amended to overcome the problem raised in *Sparrow Electric*, see *BIA*, *supra* note 2, s. 227(4.1) as am. by S.C. 1998, c. 19.

141. Thus it is a claim on unsecured assets of the debtor and falls in priority behind secured creditors.

At the point that a trustee in bankruptcy is enforcing claims and liquidating assets, courts have deferred to the scheme set out under the *BIA*. However, in reality, a number of insolvencies do not result in bankruptcy. Rather, the receiver liquidates the assets pursuant to provincial legislation under secured creditor or court supervised proceedings. What distinguishes the issue of DIP financing under the *CCAA* is that it is granted at a different point in the process and pursuant to proceedings under a statute with different legislative objectives than those of the *BIA*, specifically, providing a brief period in order to facilitate a workout with creditors.

The Supreme Court in *Sparrow Electric* also held that the court must be sensitive to personal property security regimes and the need for certainty in commercial transactions.[142] Few would disagree with this finding. However, it does not flow from the need for commercial certainty that the court has no jurisdiction to grant time-limited remedies in extraordinary circumstances in order to effect the aims of the *CCAA*. In fact, given the Canadian courts' clear guidance on when and why they will exercise such discretion, as discussed above, there continues to be sufficient certainty in commercial transactions. Secured creditors are fully aware that there may be some slight compromise of their claims in order to meet the legislative objectives, and arguably they currently factor that into their risk assessment and lending decisions. Given that the only jurisdiction in Canada in the past fifteen years that has declined to take jurisdiction to provide DIP financing is Nova Scotia, secured creditors have had certainty in their commercial transactions.[143] Moreover, in the Nova Scotia case, the court considered only the statutory language and not the court's broader equitable jurisdiction. It was heard in the early years of the renaissance of the *CCAA* and the court essentially invited parties to seek reconsideration if they could point to authority where priority had been granted for a monitor.[144] Although there appears not to have been a motion for reconsideration in that case, other Canadian courts have uniformly declined to follow the Nova Scotia court's reasoning.[145]

Secured creditors already factor the risk of firm failure into their risk assessment and decision making into the granting of credit. Arguably this includes a risk assessment of DIP financing charges under the *CCAA*. Secured creditors are the most sophisticated creditors, with the greatest

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142. *Sparrow Electric, supra* note 138 at para. 22.
143. *Re Fairview Industries* (1991), 11 C.B.R. (3d) 43 (N.S. S.C.(T.D.)).
144. *Ibid.* at 15.
145. See for example, *Royal Bank* v. *Fracmaster* (1999), 244 A.R. 93 (C.A.); *Royal Oak Mines, supra* note 66; *Re United Used Auto* (B.C. S.C.), *supra* note 73.

bargaining power and access to information in making contracts. That is precisely why the *CCAA* is aimed at interests broader than those of secured creditors. If any group of creditors has not already accounted for the risk of insolvency in the cost of credit, it is trade suppliers, employees and other unsecured creditors, who are some of the parties at whom the legislation is aimed.

A veto by secured creditors could act to the serious detriment of many other stakeholders whose interests are also accounted for in the *CCAA* process. Under the current provisions, the secured creditors are not deprived of their property rights. Rather, a comparatively small part of their claim may be compromised. In some cases that compromise is only temporary, because the workout actually provides the secured creditors with the full value of their claim, or with a much greater value than its liquidation value.

As the Court of Appeal in *Re United Used Auto* observed, if a super-priority cannot be granted without the consent of secured creditors, those creditors would have an effective veto over *CCAA* relief in many such applications.[146] The court held that Parliament did not intend that secured creditors could indirectly frustrate the objectives of the *Act*.[147] Arguably, if Parliament had intended that secured creditors have a veto, it would have expressly set that requirement in the *Act*. Since the secured creditors have full remedies and priority under private security proceedings and provincial legislation, or under the *BIA* after a *CCAA* process has failed, Parliament has allowed the *CCAA* to temper those powerful rights during the limited but vitally important workout period.

1. *Why the "Secured Creditor Veto" is neither an Alternative nor Efficient*

H.A. Zimmerman has assisted in focusing the DIP financing debate by proposing his own model for legislative change. He proposes a model in which the courts could make early determinations of class, and then have the classes vote by percentage and dollar amount on the same basis as required for endorsement of a proposed plan of arrangement, or have the court grant or withhold approval of DIP financing on their collective behalf where it is unrealistic to obtain consent. He suggests that only where the class has consented or a court has deemed the class to have consented will super-priority be given in DIP financing over a particular class.[148] Zimmerman suggests that the risk to a class seeking to protect its

146. *Re United Used Auto* (B.C. C.A.), *supra* note 3 at para. 29.
147. *Ibid.*
148. *Supra* note 109.

priority is that the DIP lender may be dissuaded from lending, thus triggering a liquidation of the debtor corporation.[149] This notion of a failure to endorse means secured creditors would be given a veto in the *CCAA* process. It would seriously shift the balance of power and interests under the statute towards the secured lenders. While I agree with Zimmerman that debtor corporations should not be seeking DIP financing without some prospect of a plan, this proposal does not require that DIP financing be granted only where there is a reasonable prospect of a plan. It merely grants a veto to senior creditors who already have the greatest bargaining power in the proceeding.

The current approach of the courts is not a total expropriation of property interests; it is a relatively small potential compromise with the risk that secured creditors will have to temporarily defer receipt of all or at worst most of their claims. In fact, in some cases, secured creditors will receive even more of their claim in a successful restructuring than they would have through a liquidation of assets under a bankruptcy. In contrast, giving these lenders a veto would expropriate the interests of unsecured creditors and others in having a reasonable restructuring plan implemented under the *CCAA*.

The difficulty with a "secured creditor veto" approach is also that it assumes no information asymmetries and relatively high sophistication among the parties early in the process. The senior secured creditors already have the greatest access to the court-supervised process and they have the information and resources to effectively argue that the court should not exercise its equitable jurisdiction to grant DIP financing in a particular case. The proposal that they be given a veto does not adequately address the interests of numerous other stakeholders such as employees, local trade suppliers, contingent creditors and others who require time to clarify their interests and seek status, counsel and information in order to effectively participate. Frequently, lack of resources and information asymmetries act as a bar to their participation. Premature definition of creditor classes in the proceeding could further disadvantage these parties by foreclosing their ability to make submissions on a key restructuring issue.

The court's precise reason for exercising its inherent jurisdiction is because the objectives of the *CCAA* are broader than solely the preservation of creditors' claims. It is unclear what implementing early voting in respect of DIP financing would constructively contribute to this process, other than to give secured creditors a veto over super-priority financing and thus likely a veto over the ability of the debtor corporation to continue

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149. *Ibid.*

operating as a going concern during the negotiations for a workout. Zimmerman does make a number of important points about the need for adequate notice and opportunity for a hearing before the court determines whether or not to grant DIP financing.[150] This is one of the key principles that should guide the courts, as is discussed in Part VI.

V. *Why the U.S. Bankruptcy Code Model of DIP Financing is Inappropriate for Canada*

Several practitioners have suggested that Canadian courts should adopt the U.S. approach to financing pending the development of a restructuring plan. The rules for such financing in the United States are more rigid and defined by Chapter 11 of the U.S. *Bankruptcy Code*.[151] The difficulty with importing these notions into the Canadian context is that the American scheme is implemented in a highly rehabilitative debtor-oriented regime and the rigid guidelines for interim financing are aimed at creating a balance between the interests of creditors and those of the debtor corporation. In contrast, the Canadian regime already substantially favours secured creditors and the *CCAA* is aimed in part at creating a balance to that priority in the limited circumstances of a workout process. Statutory priority for secured creditors in DIP financing under the *CCAA* would further tip the balance in favour of these interests to the detriment of other interests.

Under Chapter 11 of the U.S. *Bankruptcy Code,* when a party files a petition an automatic stay is imposed on both secured and unsecured creditors. The business continues to operate with the debtor in possession (DIP), which controls a new legal entity, the estate, and acquires the rights and obligations of a trustee in bankruptcy.[152] Thus the term DIP is used in a very different context in U.S. insolvency proceedings. Like Canadian courts under the *CCAA*, American judges have held that the purpose of Chapter 11 is to provide a period of time in which the debtor corporation can attempt to negotiate a reorganization plan acceptable to creditors.[153] As with Canada's regime, the U.S. scheme provides for a process of disclosure, negotiation and then voting by class for a proposed plan.[154]

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150. *Ibid.* at 16.
151. *Bankruptcy Code,* 11 U.S.C. (1988), as amended [hereinafter Chapter 11].
152. E. Warren and J. Westbrook, *The Law of Debtors and Creditors,* 3rd ed. (Boston: Little, Brown, 1996) at 398. *Supra* note 151, § 363. A trustee can be appointed under Chapter 11, but it is rare. In such cases, the trustee is a fiduciary to all parties with an interest in the estate. Anna Chou, "Corporate Governance in Chapter 11: Electing a New Board" (1991) 65 Am. Bank. L.J. 559 at 580.
153. Warren and Westbrook, *ibid.* at 397.
154. A creditors' committee can be appointed to monitor the activities of the debtor. Warren and Westbrook, *ibid.* at 399.

The failure to devise a reorganization plan acceptable to creditors in required amounts of support will lead to bankruptcy and eventual liquidation. The court in sanctioning the plan must ensure that it meets the statutory requirements including the requisite amount of creditor support.

A key difference in the U.S. scheme, which focuses primarily on rehabilitation, is that creditors have few rights to insist on an expeditious resolution of the proceedings. For example, the debtor corporation has a period of 120 days in which it exclusively can propose a reorganization plan, then an additional 60 days to have the plan accepted by creditors.[155] Thus creditors are faced with a minimum of 180 days and usually much longer before they can move to enforce their claims. American judges frequently extend this period of exclusivity, thus giving the debtor corporation greater control over the proceedings for prolonged periods of time. One U.S. practitioner recently reported that Chapter 11 cases take up to seven years.[156]

The extended stay creates an incentive to carry on business even where the value of the enterprise is worth more liquidated. Comparatively the U.S. thus differs from the Canadian regime in that creditors' rights are stayed for prolonged periods without the debtor having to be accountable to creditors. The length of the stay period often results in corporations seeking protection of Chapter 11 to prolong the corporation's business life, without there being any real possibility of the debtor corporation rehabilitating itself.[157] This is frequently to the detriment of creditors' interests and ultimately results in an untimely liquidation of the corporation.[158] Under the U.S. scheme, the stay period creates a period of

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155. *Supra* note 151, § 1121(b)(c). Moreover, there is greater ability to avoid legal judgments and it is easier to restructure assets under Chapter 11. Julian R. Franks and Walter N. Torous, "Lessons From a Comparison of U.S. and U.K. Insolvency Codes", in Jadeep S. Bhandari and Lawrence A. Weiss, eds., *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge: Cambridge University Press, 1996) at 458-9.

156. Rick Sierry, Counsel for Loewen Corporation, "Oral Submissions", (Case Conference Hearing, Ontario Superior Court of Justice (Commercial List) 12 August 1999).

157. Bruce A. Markell, "Owners, Auctions and Absolute Priority in Bankruptcy Reorganizations" (1991) 44 Stanford L. Review 69 at 69-72.

158. While corporations appear to be successful in the short term, only about 5% of cases survive for any prolonged period outside of bankruptcy proceedings. Elizabeth Warren, "Why Have a Federal Bankruptcy System?" (1992) 77 Cornell L. Rev. 1093; see also Elizabeth Warren, "Bankruptcy Policy" (1987) 54 U. Chi. L. Rev. 775. Debtor corporations also tend to forum shop in terms of state jurisdictions thought to be favourable to those in control of the corporation. Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, "The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts" (1994) 17 Harv. J. of L. & Pub. Pol'y 801 at 806. The U.S. regime has also been criticized for the growing phenomenon of multiple proceedings in which the same corporation returns to protection of the bankruptcy court for a second or third restructuring.

unaccountability because creditors cannot propose a reorganization plan, and because there is excessive delay in satisfying creditors' claims, often without value enhancement in terms of continued operations.[159] Thus the interim financing requirements are an effort to balance the interests of secured creditors in a debtor-oriented regime.

As under the Canadian scheme, creditors can ask the court to lift the stay for purposes of enforcement of their security if they can establish that it is necessary for the protection of their interests, although courts will not interfere lightly with the exclusive period.[160] The court is required to act on any request to lift a stay within 30 days or the stay is automatically lifted with respect to a creditor's collateral. The DIP has the onus of demonstrating that there is adequate protection of the secured creditor's collateral. The court will lift a stay if it determines that there is lack of adequate protection.[161] The tests for adequate protection are: periodic payments, additional or replacement liens, and "such other means of providing adequate protection as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property".[162] An equity cushion can be found to be adequate protection.

Under Chapter 11 proceedings, the debtor corporation has the right to reject unfavourable contracts and assume valuable ones, and there is suspension of accrual of interest on unsecured liability.[163] Secured creditors' interests are protected by the Absolute Priority Rule (APR) imposed by the *Bankruptcy Code*, which requires that each class of creditors receive the full value of their claims in cash or securities prior to the receipt or retention by any junior class of creditors or shareholders of any property or interest under the reorganization plan.[164] As a balance

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159. There has been a recent move to address this through pre-packaged plans for publicly traded companies where the proposed plan has already received support of key creditors and the process is expedited. The difficulty is that the initiative for this process must come from the debtor corporation and those seeking merely to defer liquidation are unlikely to use this process. Similarly, the 1994 amendments to the *Bankruptcy Code* included a fast track procedure for small businesses and single asset companies. This too is exclusively at the election of the DIP. Christopher Frost, "Bankruptcy Redistribution Policy and the Limits of Judicial Process" (1995) 74 N.C.L. Rev. 75 at 127; Karen Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* (New Haven: Yale University Press, 1997) at 121. The National Bankruptcy Review Commission, established pursuant to *Bankruptcy Reform Act of 1994*, Pub. L. No. 103-394, § 601-610, 108 Stat. (1997) proposed identification of those corporations with no chance of success in order to terminate those proceedings earlier.

160. *Supra* note 151, § 361-62.

161. Warren and Westbrook, *supra* note 152 at 398, 403, 410, 412.

162. *Re Rogers Development Corporation* 2 Bankr. 679 (Bankr. E.D. Va. 1980).

163. Post petition creditors can be offered relatively good credit terms, Warren and Westbrook, *supra* note 152 at 399.

164. *Supra* note 151, § 1129(b).

to this, there is the availability of "cram down" as a means to obtain approval of plans over the objections of dissenting creditors. This requires the court to engage in costly and time consuming valuation proceedings before approving a plan.[165] Under the cram-down rule, shareholders as the most junior claimants do not receive any value in the reorganized corporation unless creditors consent or all claims are paid in full.[166]

The American *Bankruptcy Code* has clear rules for the granting of debtor in possession financing.[167] Priority financing is granted during the stay period only where the debtor has given 15 days clear notice to creditors and a hearing is held.[168] In considering such requests the court must be satisfied that credit could not otherwise be obtained on an unsecured basis.[169] Then the court will approve any priority financing only if the interests of existing secured creditors are adequately protected.[170] This includes adequate protection of the secured party in the form of additional or replacement liens, periodic cash payments to the existing secured creditor that will counteract the decrease in value of existing secured credit, or other specific measures to ensure protection.[171] These provisions are important in the U.S. context because, unlike Canada, a corporation does not have to be insolvent to file for Chapter 11 protection.[172] It means that there is often equity remaining in the corporation, which is highly relevant to the issue of interim financing, requiring shareholders to demonstrate their commitment to reorganization by risking more of their equity. The provisions are highly codified, as is the entire *Bankruptcy*

165. Warren, *supra* note 158 at 90.

166. The only exception is where current owners contribute new value in terms of additional equity or credit, in which case they can retain the equivalent of that value without creditor consent. *Supra* note 151, § 1129. Markell points out that this "new value exception" is not really an exception because the only value that is protected in the new value injected, as it would be with any new investor. Where it is beneficial is as a signal of the confidence of the shareholders in possible turn around given their willingness to risk new capital. *Supra* note 157 at 111. See also Kevin A. Kordana and Eric A. Posner, "A Positive Theory of Chapter 11" (1999) 74 N.Y.U. L. Rev. 161 at 195.

167. Warren and Westbrook, *supra* note 152.

168. Zimmerman, citing Rules 4001(c) and 9001 (6)(c)(2) of Chapter 11, *supra* note 109 at 16. This notice and hearing requirement are not required for unsecured post-filing financing in the ordinary course of business for actual and necessary costs of preserving the DIP, Rotsztain, *supra* note 2 at 287.

169. Warren (1992), *supra* note 158.

170. *Supra* note 151, § 361, 364.

171. *Ibid.*

172. This is to encourage corporations to restructure their affairs before the corporation reaches the point that it is hopelessly insolvent and therefore unlikely to reorganize successfully Lynn M. Lopucki, "A General Theory of the Dynamics of State Remedies/Bankruptcy System" (1982) Wisc. L. Rev. 311 at 311.

Code and the provisions protecting secured creditors are crafted as a balance to the considerable control that the DIP continues to exercise for prolonged periods under a Chapter 11 workout.

Some practitioners have argued that Canadian law should adopt the American approach to interim financing, arguing that the law should facilitate the efficient operation of free financial markets, and that the debtor will obtain financing where there is economic incentive to fund.[173] Yet the U.S, model is far from a free market system, in fact it is more highly codified and less subject to market variations than Canadian insolvency law. For example, there is no requirement that the debtor demonstrate the acceptability of the restructuring plan to the creditor marketplace within a relatively short period of time, as there is in the *CCAA*.

The Canadian regime, which is highly time sensitive in terms of protecting creditors' interests, may not be appropriate for the time consuming and costly valuing process involved in granting workout financing under the U.S. scheme. The Canadian regime has adopted a pragmatic and expeditious process, allowing very time-limited funding without the enormous cost and delay required in precise evaluation of creditors' claims prior to granting that interim financing. The short stay periods, and the granting of DIP financing on an urgent and necessary basis, already serve to protect creditors. It allows both the debtor corporation and creditors a short period in which to gain a fuller understanding of how the assets are being utilized and whether there is a chance for a workout. Any additional financing relief is only granted where the court is persuaded that there is sufficient creditor support and the debtor corporation has a reasonable prospect of developing a viable business plan. Prolonging the stay period to undertake a valuation may hamper, as opposed to enhance, that protection.

Both the American and Canadian regimes are aimed at balancing diverse interests in restructuring within their larger bankruptcy schemes that are debtor-oriented and creditor-oriented respectively. The *BIA* grants powerful rights to secured creditors at the point of bankruptcy in order to aid debt collection and create certainty in lending decisions. The *CCAA* tempers for a very limited time period the powerful remedies of secured creditors, by taking into account the interests of all stakeholders in the restructuring process. The U.S. bankruptcy scheme tempers the powerful remedies of the debtor corporation during the prolonged period that it can remain in Chapter 11, by better balancing creditors' interests

173. Zimmerman, *supra* note 109.

during this period. Importing the U.S. interim financing model into the Canadian regime would shift the current balance of power towards those that the Canadian scheme already favours.

VI. *Principles that Courts Apply in the Granting of DIP Financing*

The above discussion illustrates that Canadian courts have attempted to find the optimal balancing of prejudices in the exercise of their jurisdiction to grant DIP financing or other priority and DIP financing charges. The courts have exercised their equitable jurisdiction to grant super-priority financing in appropriate cases. On the whole, the courts have been quite balanced in their reasoning and have developed principles in order to guide parties and create certainty in both credit transactions and proceedings under the *CCAA*. While legislative amendment would clarify this exercise of jurisdiction, courts would still have to engage in a balancing of all the interests involved before making a decision.

It is important to draw out the principles being applied by courts in the exercise of their jurisdiction to grant DIP financing. A careful reading of the cases indicates that there are five principles currently operating in the courts' consideration of applications for DIP financing: adequate notice, sufficient disclosure, timeliness of the request, balancing the prejudice, and the principle of granting priority financing as an extraordinary remedy. While these are not always concisely and clearly articulated, the cases discussed in Part III illustrate that they are the underlying principles at work. Moreover, as courts have acquired experience in consideration of DIP financing applications, these principles have become clearer and more focused.

1. *Adequate Notice*

Practitioners in the past have correctly criticized the courts for granting DIP financing on a few hours or no notice. This had been a growing problem until the late 1990s. At that point, the courts began to clarify the importance of adequate notice before they will consider such requests.

Courts have held that they would not consider DIP financing requests on an *ex parte* basis or without adequate notice.[174] They have held that they will grant only enough financing to "keep the lights on" for a brief but urgent period where there has been inadequate notice.[175] Judges have increasingly considered with caution priority financing requests in initial orders, holding that parties are entitled to a reasonable opportunity to

174. *Re United Used Auto* (B.C. S.C.), *supra* note 73.

175. *Re Royal Oak Mines*, *supra* note 98.

determine how their claims will be affected by the request for priority financing. Adequate notice is a prerequisite except in extraordinary circumstances, and then for only limited time periods and amounts. If a debtor corporation is seeking to compromise claims, even in extraordinary circumstances, creditors should be given adequate notice.

Although courts typically build in comeback clauses in their initial orders, granting DIP financing orders on an initial *ex parte* application acts as a deterrent to parties who feel there is a hurdle to overcome in overturning the initial order. Where a court grants limited financing on an *ex parte* basis, it will only be long enough to give adequate notice to creditors with a clear indication that the court will hear creditors' views on the issue. Limiting the period of any initial financing also places the onus of justifying any additional financing on the debtor corporation, which has the best access to information necessary for the court to determine if further financing is justified.

Where the courts have been slightly less consistent, but are increasingly concerned, is in giving notice of a DIP financing request to *all* interested parties. Typically, even where notice is given, it is not given to employees or their bargaining agents, and frequently not to landlords, suppliers, or other unsecured creditors. Given that the exercise of the courts' equitable jurisdiction to grant priority financing is for the benefit of all creditors, then those diverse creditors must be given access to the process so that a judge can hear their views. The court will thus be in a better position to assess the request for priority or DIP financing, be it funding for the monitor to facilitate the development of a viable plan, or financing to carry out business operations during the *CCAA* process.

2. *Sufficient Disclosure*

Another recurring principle in the judgments is the need for sufficient disclosure so that creditors can fully assess the impact of DIP financing decisions. For example, is there still equity remaining in the corporation such that priority financing is not required? Is the financial picture such that it is realistic to continue operations pending the workout? The courts have been effective in directing the monitor to report to the court on the financial and business affairs of the corporation. This has included adequate valuing of encumbered and unencumbered assets, to ascertain the nature and type of pre-insolvency debts, and to determine whether there is equity remaining. This must be done early enough in the process so that all interested parties can assess the DIP financing request in an informed manner.

The principle of requiring sufficient disclosure allows parties to review information and consider their positions. Parties are to be afforded a reasonable opportunity to assess the impact of priority and DIP financing, and to consider whether the *CCAA* process or receivership and bankruptcy is the most appropriate course of action.[176] The debtor has an obligation to disclose sufficient information to allow both secured and unsecured creditors, as well as other stakeholders, a chance to make an informed and realistic decision regarding whether they support the DIP financing request. In turn, this will enhance the court's consideration of the request and exercise of discretion.

3. *Timeliness of the Request*

This is clearly a principle in the courts' consideration, although judges have occasionally been inconsistent in the reasoning they use in respect of timeliness in granting the stay, and, as a result, in granting priority financing for the monitor, professionals and continued operations. A clearer articulation of this principle could assist the parties in *CCAA* proceedings.

While the *CCAA* is a process of last resort for debtors, courts should take into account the timing and prior conduct of debtors in making a determination to grant or maintain stays. There are good policy reasons for attempting a private workout with creditors, and thus a debtor may not apply for protection until that avenue has been exhausted and creditors are moving to enforce their claims. In such cases, it may be reasonable for a court to exercise its discretion to grant the stay, and then, where appropriate, order a priority charge for the fees and disbursements of the monitor and/or DIP financing.

However, there is a difference between good faith efforts to make arrangements with creditors and then seeking the protection of the court in aid of these efforts, and a situation where the debtor engages the court only to defer liquidation without any real prospect of devising a business plan acceptable to creditors. In such cases, it is reasonable for a court to determine that a stay is not appropriate, that the debtor has been untimely in the application, and that the court will not exercise its discretion to grant the stay. Super-priority financing is then no longer an issue, and creditors' interests are fully protected. Similarly, in considering whether to extend the stay or a consideration of additional requests for DIP financing, a court should be rigorous in assessing the timeliness of the request. It must determine whether there is a possibility of achieving a plan such that the

176. *Ibid.*; *Canadian Red Cross, supra* note 29.

debtor should be afforded the continued protection of the stay, any priority financing, and the continued temporary suspension of creditors' enforcement rights.

4. Balancing the Prejudice to All Stakeholders

Where equitable remedies are being granted, a court must balance the specific relief against the burden of that form of relief to other parties.[177] That is precisely the principle that Canadian courts have applied to requests for priority and DIP financing. The court considers the amount of relief sought, the relative amount of burden on secured and other creditors in terms of the overall debt, the prospect of devising a feasible business plan in a short time frame, the risks to employment, the risk of firm failure to the local economy, any remaining equity interest of shareholders, and a variety of other considerations. If specific relief advances the statutory objectives and protects a variety of investments and interests in the corporation, and in balancing that, the overall prejudice to secured creditors is small, then the court will exercise its discretion to grant priority financing.

Review of the courts' decisions indicates that the threshold for granting financing for monitors' fees has been lower than that of DIP financing for continued operations. This is because the courts have consistently recognized that the monitor is acting to protect the interests of all creditors. The courts have held that where it is appropriate to grant an initial stay, the role of the monitor is both mandatory under the *CCAA* and is key to facilitating a timely, informed and successful process to develop and negotiate a plan of arrangement or compromise. Thus it will grant orders creating a priority charge for the reasonable fees and disbursements of the monitor. The court will also grant such priority charges for representative counsel of employees, pensioners or consumers, or charges in favour of other professionals where it is satisfied that such financing is essential to the *CCAA* process.

The courts have generally set a higher threshold for DIP financing aimed at ongoing operations. Here, in balancing the interests and prejudices, the parties will consider the quantum of relief and expected benefits, as well as the amount of prejudice to secured creditors. A court will consider whether there is an urgent need for the financing to perform environmental maintenance or "keep the lights on" for a brief period while the debtor seeks additional financing or investment.[178] In balancing the prejudice, a judge will also consider the likely gains for stakeholders if there is a

177. Waddams, *supra* note 76 at 521.
178. *Re Royal Oak Mines*, *supra* note 98.

successful restructuring.[179] The courts have held that where the debtor corporation can establish that this is a necessary requirement for the formulation of a plan, or that it is reasonably important to maintain operations to protect diverse interests and preserve the value of the corporation in order to devise a successful turnaround plan, the court may exercise its discretion to order the DIP financing.[180] In this, the courts will consider any erosion and the rate of erosion of secured creditors' interests and are unlikely to grant the financing where it would be too prejudicial to their interests. Judges will require cogent evidence that the benefit of DIP financing clearly outweighs the potential prejudice to secured creditors.[181] Where creditors have a high level of distrust or lack of confidence in the directors and officers, the court will not order such financing.[182]

5. *Extraordinary Remedy*

The clearest principle enunciated frequently by the courts is that DIP financing is an extraordinary remedy and is available only in limited amounts for a very brief, but realistic, period in the workout process. As with equitable remedies generally, the exercise of this discretion has been aimed at ensuring fairness in the process, and aimed at ensuring the substantive objectives of the *CCAA* are met. Firm judicial control over amounts of financing, over the precise purposes and use of such funding, and over the accountability of the debtor to the monitor and the court, ensures that this remedy does not undermine or exceed the purpose of the *CCAA*. It also ensures that this extraordinary remedy does not conflict with or undermine the purposes of the *BIA* should the workout fail and the parties enforce their remedies under the bankruptcy regime.

The argument that there is a need for certainty in credit transactions is an important one. However, secured creditors already take account of the risk of insolvency in their credit decisions. Given the existence of DIP financing and administration charges for the past fifteen years, secured lenders arguably already take account of these costs in their credit decisions. In addition, in some circumstances, secured creditors will suffer no loss or may even realize a greater amount of their claim as a

179. *Re Skydome, supra* note 55; *Royal Oak Mines, supra* note 66.
180. *Re Dylex, supra* note 29.
181. *Re United Used Auto* (B.C. S.C.), *supra* note 73; see also *Re Sharp-Rite Technologies*, [2000] B.C.J. No. 135 (S.C.), online: QL (BCJ).
182. *General Electric Capital Canada* v. *Euro United Corp.* (24 December 1999), Toronto 99-CL-3592 (Ont. Gen. Div.), Blair J..

result of a successful restructuring plan, than they would have been able to realize on a liquidation.

6. *Are Statutory Guidelines Necessary?*

The above-cited principles illustrate that Canadian courts have developed guidelines that have fostered certainty in credit transactions and proceedings under the *CCAA*. Recently, however, some practitioners have suggested that there should be statutory guidance. These range from those who advocate that there is currently no jurisdiction absent statutory amendment,[183] to those who believe that the court has jurisdiction, but that it could be enhanced by statutory guidelines.[184]

Some practitioners have expressed concern that the courts' practice of weighing the prejudice has somehow created uncertainty in the decision making on DIP financing. Yet the entire process under the *CCAA* is one of weighing the relative interests and prejudices to stakeholders, from the initial order to the fairness inquiry on the sanctioning of a plan, and numerous interim matters. While legislation could specify that the courts must respect the rights of both debtors and creditors, that is precisely the exercise engaged in by the courts now.

While it is true that legislative amendment would give direction and certainty to parties in their consideration of whether to endorse requests for DIP financing, it has the danger of unduly binding the court. One of the underlying reasons for the *CCAA* was to facilitate compromises and arrangements. Its flexibility has allowed parties to craft plans of arrangement that are creative and have a high probability of success.[185] Moreover, if legislation only allows DIP financing where secured creditors agree, as an example, then creditors will be given an effective veto over the workout process. This will have serious negative consequences for employees, trade suppliers and other unsecured creditors, who already have the least bargaining power in the workout process. Such a requirement would undermine the objectives of the *CCAA* and run counter to the thoughtful jurisprudence that has evolved over the past decade, and which has tried to balance the diverse interests of all stakeholders in the workout process.

Rotsztain suggests that there should be introduction of statutory amendments on DIP financing to give both procedural and substantive guidance, but that the rules should not be so extensive or rigid that the advantages of the current flexible regime are lost.[186] The codification that

183. See for example, *Motion Record* in *United Used Auto, supra* note 132.
184. Rotsztain, *supra* note 2 at 290.
185. See for example, *Algoma Steel, supra* note 36; *Canadian Red Cross, supra* note 29.
186. *Rotszain, supra* note 2.

he advocates is essentially the approach already applied by the courts and described above: notice, disclosure, preservation of assets for all creditors, time for stakeholders to prepare a plan to avoid the social and economic consequences of bankruptcy.[187] One issue not discussed above is where the debtor satisfies the court that the borrowed funds are to be used to pay amounts that enjoy legal priority over the interests of existing secured creditors, where the payments would not materially prejudice the debtor's assets or business.[188] Rotsztain suggests that all of these grounds may be so compelling that the debtor corporation would not need to justify adequate protection for creditors, and that creditors would still be able to oppose such funding and ask the court not to exercise its discretion.[189]

While this codification might create greater certainty, it reflects precisely what the courts are doing now, using the flexibility of the process to ensure a proper balancing of creditor and other stakeholder interests. It is worth noting that in the current debate about whether DIP financing should be the subject of statutory amendment, there are no cases cited in which the courts have failed to exercise their discretion reasonably and in a restrained manner. Thus it is unclear why statutory amendment is required.

Having made that observation, one factor the courts could first consider is whether there is any equity remaining in the corporation. In such cases, they could require that shareholders secure the DIP financing against that equity. This would mandate an early determination of the value of the assets and may lead to unnecessary expense and delay in the process. The American system of costly and time consuming valuation has highlighted this problem. However, there may be compelling reasons for a court finding that, in order to continue the workout process, shareholders must demonstrate their confidence in the future of the corporation by risking some or all of the remaining equity investment. This is quite different from requiring shareholders to add additional capital and risk equity beyond their original investment decisions. It could be part of the balancing that courts currently engage in when considering whether or not to grant priority financing.

Both the *CCAA* and the *BIA* specify that bankruptcy and insolvency legislation is to be reviewed by a parliamentary review committee in the spring of 2002.[190] The federal government has announced that the issue of debtor-in-possession financing is an area in which it will consider legislating. In a recently issued consultation paper, Industry Canada has

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187. *Ibid.* at 291.
188. *Ibid.* at 292.
189. *Ibid.* at 293.
190. *BIA*, *supra* note 2, s. 216(1),(2); *CCAA*, *supra* note 1, s. 22(1),(2).

suggested that codification of the courts' jurisdiction to order DIP financing may create greater certainty in credit decisions.[191] The paper is the first stage in a consultation process by the federal government that is to take place in the fall of 2001. The paper suggests that the court's granting of priority financing under the *CCAA* has had both efficiency and fairness effects. It is efficiency enhancing in the sense of allowing debtor corporations to overcome risk aversion of existing lenders and allowing corporations with viable business plans to survive. Thus it is a positive intervention in the marketplace. DIP financing can also be efficiency reducing in that it creates uncertainty in initial lending decisions if there is uncertainty in how the courts will exercise their jurisdiction under the *CCAA*.[192] The fairness issue is one of balancing diverse interests in the workout process, where the courts balance the interests of wage earners, suppliers and local communities with those of senior secured lenders.

The consultation paper offers several possible options for codification of DIP financing, without making any particular recommendation this early in the process. One possibility is that new creditors providing DIP financing would be required to share on equal or proportional terms with banks as senior lenders, in terms of priority in security over liquid assets, based on a specified formula.[193] This approach has some merit in that it prevents existing secured lenders from having an absolute veto on financing to facilitate the reorganization, while protecting their priority status. It would also encourage DIP lenders to advance credit, although it would not be on a full priority basis. Such an approach may enhance both the availability of work-out financing and initial lending decisions.

The consultation paper also suggests that "opting-out" may be legislated, such that creditors, in initial lending decisions, could contract with debtor corporations to opt-out of any statutory provisions that would allow for DIP financing on insolvency. Such a statutory amendment may ultimately work to defeat the availability of DIP financing during the workout process, and thus lead to premature liquidations. Senior secured lenders, who always have the bargaining power to secure such agreements, would likely make opt-out clauses a standard provision in initial lending contracts. Such an approach fails to address all of the information asymmetries and bargaining power problems addressed above. It would merely shift the veto of secured creditors to the initial lending stage, as

191. Industry Canada, Corporate Law Policy Development, "Efficiency and Fairness in Business Insolvencies" (Ottawa: Industry Canada, 2001) at 37.
192. *Ibid.*
193. *Ibid.* at 39.

opposed to the insolvency stage, to the detriment of the diverse stakeholders that the granting of DIP financing is currently aimed at.

The federal consultation process will also consider whether to amalgamate the workout provisions of the *BIA* and the *CCAA*, either by eliminating the *CCAA* entirely, moving it intact into the *BIA*, or crafting an integrated reorganization section within the *BIA*.[194] Aside from larger and important public policy questions regarding the implications for diverse stakeholders in this question, there are also implications for DIP financing. An amalgamation of the reorganization provisions could lead to removal of the court's jurisdiction to grant DIP financing, given the highly codified requirements of the *BIA* and the lack of certainty as to whether the courts can currently grant such financing under the *BIA*. Secondly, the ability of the courts to supervise the parties under the *CCAA* in a flexible and highly creative manner may be lost with an amalgamation of the statutes, including the ability to supervise priority financing that balances diverse interests at risk with the insolvent corporation. Third, it may be difficult to recognize and reconcile the differing rehabilitative and liquidation objectives of the statute if the *CCAA* and *BIA* are amalgamated. These issues must be carefully considered in the upcoming policy debates regarding the future of the *CCAA*.

Rotsztain does offer a valuable suggestion with respect to the judicial approach to extensions to initial financing. He suggests that statutory guidelines could direct a court to exercise its discretion in the same manner as now provided for in granting extensions to the initial stay under the *CCAA*, specifically, that the court would not make an order for additional DIP financing unless the debtor satisfies the judge that circumstances exist that make the order appropriate and further satisfies the court that it has acted and continues to act in good faith and with due diligence.[195] Although such a codification would give clear direction to a court, it is also a test that could be applied under the current statutory scheme.

Thus codification could be helpful, but is unnecessary. My concern is that many of those advocating legislative change do not want to codify the existing principles applied by courts. Rather, they want to create a secured creditor veto in the workout process, as discussed in Part IV above. Should Parliament decide that some statutory codification is required, it should be cognizant of the fact that granting a *de facto* veto to secured creditors would unfairly tip the balance of interests under the legislation, to the detriment of those creditors who are already the most vulnerable in

194. *Ibid.* at 43-47.

195. *Rotszain*, *supra* note 2, at 293, citing *supra* note 1, s. 11(6).

the process, such as employees, trade suppliers, consumers and tort claimants. As a consequence, any statutory amendment should be aimed at codifying the principles already being applied by judges, specifically: notice, adequate disclosure to stakeholders in order for them to determine their position on the DIP financing request, requirement of timely requests for financing, and recognition of the need for the court to balance the interests of all stakeholders affected by the insolvency of the debtor corporation.

Conclusion

The degree of uncertainty created by the courts' granting of DIP financing in its various forms may have been exaggerated. In addition, whatever uncertainty remains must be balanced against the need to provide such financing, in appropriate circumstances, in order to further and realize the aims of the *CCAA* in protecting the interests of all creditors and the public interests in the continued operation of corporations where the prospects of successful reorganization exist. The need for certainty in the workout period may require not statutory amendment, but, rather a clear articulation of the principles on which the court is making its decisions. As noted above, courts have gone a long way towards creating this certainty in their judgments.