



The New "Insolvency" Test: Restructuring Before Your Business Literally Runs Out Of Money

By Vern W. DaRe, T: 416.865.6641, vdare@gardiner-roberts.com

Does a troubled business truly have to be insolvent or in its "death throes" before it can seek court protection from creditors? Recent rulings in the restructuring hearings for steel giant Stelco Inc. suggest a debtor company need not wait until the last minute before filing for protection.

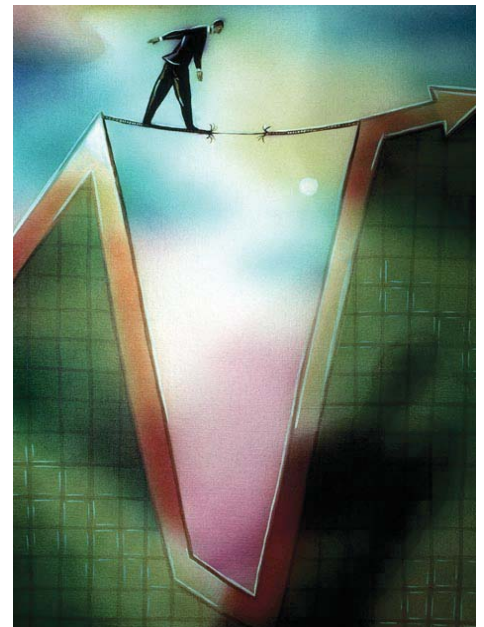
In most business restructurings where court protection from creditors is sought, the question of whether there is an "insolvency" is often moot. The dire financial position of the debtor is clear.

However, what if a business is not

yet "out of money" or technically insolvent? Is it entitled under Canadian law to submit a restructuring plan to the courts and seek protection from creditors? In the past, it was often the case that our courts would not grant protection to businesses or individuals that were not truly "insolvent" or could meet some of their debts.

Recent court rulings in the case of Stelco Inc.'s restructuring, though, have opened the door to a more liberal "reasonable foreseeability" test for insolvency. While not all courts are yet

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How Corporate Culture Affects Constructive Dismissal Claims

By Warren S. Rapoport, T: 416.865.6776, wrapoport@gardiner-roberts.com

When corporate culture changes, be it from a merger, acquisition or the vision of a new President or CEO, it can lead to variations in the employer-employee relationship that plant the seeds for a constructive dismissal claim down the road. Here are some thoughts on how to avoid problems...

Every business has a corporate culture, but it is often hard to describe. For example, is your organization egalitarian or authoritative? Collaborative or competitive? Inclusive or hierarchical? These are

the adjectives we often hear to describe the culture of an organization and it's becoming increasingly important to understand how your organization's culture is perceived by employees.

The corporate culture of a business is not easily identifiable from the outside nor does it alone define the

employment contract between an employer and employee. It can, though, affect the way an employee carries out his or her job description, how he or she reports to managers and the corresponding response the individual expects in return.

More important, radical changes

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Insolvency Test

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inside, it appears to be the start of a trend recognizing that businesses or individuals need not be on "last legs" to have court-sanctioned protection for restructuring.

For many businesses experiencing rough times, such as those dependent on a low Canadian dollar, this could buy much needed time to continue operating and restructure without the trauma of truly being insolvent.

There is generally no insolvency requirement to file under Chapter 11 of the U.S. *Bankruptcy Code*. In other jurisdictions, "financial distress" will suffice to qualify for a restructuring filing. In Canada, the federal Bankruptcy and Insolvency Act (BIA) and the *Companies' Creditors Arrangement Act* (CCAA) leave the issue less clear.

For example, the BIA defines an "insolvent person" as someone who is not bankrupt and who resides, carries on business or has property in Canada with provable liabilities of \$1,000 or more to creditors and:

- Who is for any reason unable to meet his obligations as they generally become due,
- Who has ceased paying his current obligations in the

ordinary course of business as they generally become due, or

- The aggregate of whose property is not, at a fair valuation, sufficient, or, if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable payment of all his obligations, due and accruing due.

Various tests are often applied by the courts to determine whether there is insolvency worthy of court protection. In *Stelco's* case, it was found to be a "debtor company" and worthy of legislative protection. The judge in the case adopted a new and liberal "reasonable foreseeability" insolvency test for the CCAA that should help many other companies in financial straits.

A New Test for Insolvency

Under the new test for insolvency, a financially troubled corporation is insolvent if it is reasonably expected to run out of liquidity within a reasonable proximity of time as compared with the time reasonably required to implement a restructuring.

The judge in the *Stelco* case recognized that "time is a

Constructive Dismissal

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in the employment relationship can later result in legal claims of "constructive dismissal."

Constructive dismissal is any significant change to an employee's relationship that detrimentally affects fundamental terms of the employment agreement. If constructive dismissal is present, an employee can resign and later obtain damages - just as if he or she was terminated without "just cause."

Constructive dismissal claims traditionally arise in cases where an employer demotes, transfers or reduces the pay of an employee.

However, as constructive dismissal cases become more liberalized by the courts, successful claims arising from perceived negative changes in corporate culture are becoming a new reality.

The Key Question

An employer often perceives it has sound business reasons for changing the culture in an office environment. For example, changing from a "country club" atmosphere to a "brass tacks" operation. Employees (frequently, senior employees), however, may not see the advantages of these changes - particularly if they are no longer consulted or included

in the decision-making process, when they have traditionally been involved.

The key question courts now ask in cases involving reorganizations and other shifts in corporate culture is whether there has been a "fundamental change" to the employer-employee relationship. Particularly, recent cases have considered the contribution an employee makes and expects to make in the future, based on the perceived corporate culture of the business. These court cases have provided an implicit endorsement of the importance of corporate culture in the employment relationship.

precious commodity" in the early stages of a restructuring. Specifically, he wrote that: "[T]here would not be much sense in providing for a rehabilitation program of restructuring/reorganization under either statute if the entry test was that the applicant could not apply until a rather late stage of its financial difficulties with the rather automatic result that in situations of complexity of any material degree, the applicant would not have the financial resources sufficient to carry through to hopefully a successful end."

What It Means For Businesses

The *Stelco* case now allows a court to look into the finite future to allow "entry" into the rehabilitative process if there is a reasonable foreseeable expectation of insolvency at the time of filing. In other words, a debtor need not wait to the "last moment" of its "death throes" before filing for protection. By allowing a "reasonable cushion" of time under this new test, the remedial goals of Canada's legislation are better served.

The judge in the *Stelco* case recognized that some may try to take advantage of this liberal approach to avoid paying debts, but he rejected the suggestion it would open the "floodgates" to improper or abusive filings since it can be

controlled through judicial discretion. Other courts may, however, be more receptive to the "floodgates" argument. Some are already taking a more conservative approach and closely examine claims of "due and accruing due" financial obligations — limiting them to those currently payable or properly chargeable to the accounting period during which the insolvency test is applied. For example, in one case, mass tort claims were considered too speculative and remote, being based on "possibilities rather than probabilities" to be "due and accruing due."

Clearly, though, "traditional" insolvency is no longer a prerequisite to restructuring under the BIA and CCAA. After *Stelco*, a debtor can qualify under a more relaxed insolvency requirement. If, at the time of filing, there is a "reasonable foreseeable" expectation of a liquidity problem or a "hypothetical" deficiency of assets to obligations, the debtor will satisfy the insolvency requirement.

For many businesses seeking court protection, this distinction will not matter since most debtors filing under the BIA or CCAA are in financial difficulty. For other businesses, however, there may be a new remedy in the wings to get back on track to financial stability. ◆

What Should Employers Do?

First, it is important to recognize that constructive dismissal issues may arise even where there is no apparent change in remuneration

contemplated. For example, mergers, acquisitions, new senior management (President and CEO) and any restructuring.

Experience has shown that

A change in culture can have an impact on any employee, not just a senior level executive

or responsibility. Second, as the courts have demonstrated recently, what is fundamental to an employment relationship is an ever-changing concept.

Employers should be most alert to constructive dismissal pitfalls whenever major changes are being

contemplated. For example, mergers, acquisitions, new senior management (President and CEO) and any restructuring. Experience has shown that

constructive dismissal claims often arise in changes from egalitarian to authoritative cultures and changes from inclusive to top-down decision-making. Whenever there is to be a change in the corporate culture, it is advisable that the aims of the

organization be articulated to affected employees in advance and that they be included in the decision-making, if they have traditionally had such involvement.

If any employee claims to be detrimentally affected by a reorganization or change in reporting or consulting, it should be responded to as quickly as possible to create a written record. The employer should shine as favourable a light on the changes as possible so as to prevent an employee from building a case for constructive dismissal arising from a lack of consultation or change in culture.

And, of course, legal advice should be used in a consultative capacity along the way. ◆

Bankruptcy Reform Update

Businesses may see some significant changes to Canada's bankruptcy and insolvency legislation in the near future as another round of reforms winds its way toward Parliament and lawmakers.

By Vern W. DaRe, T: 416.865.6641, vdare@gardiner-roberts.com

With a third round of possible amendments to Canada's *Bankruptcy and Insolvency Act* (BIA) and *Companies' Creditors Arrangement Act* (CCAA) looming in the coming months, bankruptcy reform could soon be a hot topic.

The first major round of amendments was in 1992 and a second came in 1997. Since then, the changing dynamics of our economy have created a need for reforms on many fronts. One Parliamentary report that provides insight into what the amendments may look like is the Report of the Standing Senate Committee on Banking, Trade and Commerce, entitled: *Debtors and Creditors Sharing the Burden: A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act*.

The major recommendations of the Committee, as they relate to commercial insolvencies, include:

- Better protection for unpaid wages and vacation pay
- Codification of Debtor-in-Possession (DIP) financing
- Repeal of the unpaid suppliers provision
- Adoption of the international UNCITRAL Model Law
- A statutory right to disclaim or assign executory contracts
- A return to pre-1997 treatment of workers compensation claims in bankruptcy
- Clarification of the interim receiver's role
- A due diligence defence for directors of insolvent companies and a provision requiring replacement of directors where the debtor's governance structure is impairing the reorganization
- A statutory right allowing going-concern and asset sales
- Exemption of certain administrative and regulatory proceedings from the stay of proceedings

- A consistent and simplified voidable preferences and transfers regime in bankruptcy and a uniform priorities regime in bankruptcies and reorganizations, and
- Clarifying the treatment of shareholders

What is not recommended by the Committee is, among other things, the merger of the BIA and CCAA regimes, and a detailed codification for claims-bar dates and mass tort claims based on the U.S. *Bankruptcy Code*. Here, though, is a selected view of what we may see:

Protecting Wage Earners: With employee claims ranking only fourth among preferred creditors and limited to \$2,000, employees are particularly vulnerable. After considering several options, the Committee supported allowing individual employees "super priority" over secured claims, limited to certain assets such as inventory and accounts receivable up to \$2,000.

Codifying DIP: With no express statutory power to authorize DIP financing, courts have had to rely on their inherent jurisdiction. The Committee has recommended a codification that would authorize the court to grant super-priority DIP financing. Given the possible prejudice to other creditors whose security is subordinated by a DIP order, the Committee also recommended that prior notice of DIP proceedings be given.

Repealing Section 81.1: This section of the BIA confers rights on unpaid suppliers of goods to reclaim goods supplied to a debtor within 30 days after delivery, provided the debtor is bankrupt or in receivership, the goods have not been resold and can still be identified, and provided several other conditions are satisfied. The protection of unpaid suppliers under s. 81.1 of the BIA is more symbolic than real. With so many problems in making it work, the Committee recom-

mended it be repealed and not replaced. The section was ineffective, unfair to unsecured creditors and not the only remedy available to unpaid suppliers.

Adopting the *UNCITRAL Model Law*: While the United Nations *Model Law* has not yet been adopted by Canada, the Committee's support for its adoption may be viewed as part of the trend towards greater harmonization of rules for the recognition of cross-border insolvency proceedings. It focuses largely on the recognition of foreign insolvency proceedings and protection of the assets of foreign estates.

*One thing is for certain and
that is that reform is once
again in the air*

Disclaimer and Assignment of Executory

Contracts: Unlike Canadian law, the U.S. *Bankruptcy Code* contains a comprehensive set of rules that cover all kinds of executory contracts regardless of the nature of bankruptcy proceedings. The situation is “piecemeal” in Canada, governed by wide judicial discretion. The Committee recommended the legislation be amended to permit a general right of disclaimer or assignment of all executory contracts, subject to satisfying certain conditions. For example, in an assignment, the proposed assignee must satisfy a credit-worthy test and be willing to compensate the other party for any pecuniary loss resulting from the debtor's default.

Pre-1997 Treatment of Workers' Compensation

Claims: Over time, workers' compensation board claims in bankruptcy have gone from preferred to secured to unsecured creditor status. The Committee wants such claims to rank in priority to unsecured creditors.

Clarifying the Interim Receiver's Role: Interim receivership orders have evolved from being protective and limited in scope to being expansive and sweeping.

Courts have also begun to question just how “interim” they are in light of overly broad, declaratory and legislative orders appointing interim receivers. The Committee recommended a clarification of the role, duration and meaning of “interim” receivers. It believes “interim” should mean “interim.”

Directors: The Committee has proposed a general “due diligence” defence for directors under the BIA. Currently, a director faces various liabilities depending on the legislation in question. Another recommendation would provide courts with the authority, if required, to replace management and directors of a debtor company during reorganization proceedings.

Approving Going-Concern Sales: Courts have been forced to rely on inherent jurisdiction to approve going-concern asset sales during CCAA proceedings. To remedy this, the Committee recommended legislative guidance on when and how such sales should be conducted by the parties. The Committee believed, subject to court approval, the debtor should be permitted to sell all or part of its assets during reorganization free and clear of the interests of secured creditors.

Uniformity in Priorities Schemes: The priority scheme in the BIA for creditors does not expressly apply to CCAA proceedings or to receiverships. To promote fairness and uniformity, the Committee recommended the CCAA be amended to incorporate the BIA priority rules.

Clarifying the Treatment of Shareholders: Both the BIA and the CCAA are silent on the treatment of shareholders. For example, neither Act expressly grants the courts authority to reorganize share capital. Nor does Canadian law expressly subordinate shareholder or equity damage claims in favour of unsecured creditors as in the U.S. Also missing in Canada are simplified tax procedures for the conversion of debt into “distress preferred shares.” The Committee recommended the BIA be amended so

that claims of a seller or purchaser of equity security can be subordinated to the claims of ordinary creditors. The Report also recommended these claims should not receive proceeds of the restructuring until other creditors have been fully paid.

What's Next?

Only time will tell whether the Senate Report is adopted into legislation. Many of the recommendations, however, are supported by practice, case law and other reports, and should therefore be looked upon favourably by Parliament. What are most likely to be controversial will be the recommendations to:

- Create a super-priority for unpaid wage claims using inventory and accounts receivable

- Repeal the section dealing with unpaid suppliers
- Grant a statutory right to disclaim or assign executory contracts
- Return to the pre-1997 treatment of workers' compensation claims in bankruptcy, and
- Create consistent and simplified rules for challenging preferences, conveyances and reviewable transactions.

For example, employees themselves may oppose the super-priority for unpaid wages as not going far enough in that it is limited to just \$2,000 and inventory and accounts receivable. Secured creditors, on the other hand, may view the priority as inconsistent with their rights.

One thing is for certain and that is that reform is once again in the air. ◆

Employers Could Be Ticketed For Employment Standards Violations

By Warren S. Rapoport, T: 416.865.6776, wraoport@gardiner-roberts.com

The Ontario Ministry of Labour has expanded its enforcement arsenal by giving designated provincial investigators the authority to use tickets to fine employers that fail to comply with the *Employment Standards Act, 2000*.

Ontario's employment standards legislation sets out the minimum terms and conditions for employment in workplaces, such as payment for overtime hours, vacations, termination notices and severance pay.

Amendments to the *Provincial Offences Act* now allow authorized employment standards officers to issue tickets for three types of offences.

- 1) Administrative and enforcement offences (for example, failure to retain records)
- 2) Contraventions of wage-based employment standards (for example, failure to pay overtime pay)
- 3) Contraventions of non wage-based employment

standards (for example, requiring employees to work hours in excess of daily or weekly limits)

Generally, according to the government, tickets will be issued for less serious violations that do not raise complex factual or legal issues. The ticket will be issued directly to the employer responsible for the offence.

The tickets carry set fines of \$300, with a victim fine surcharge added on top. The money collected from the fines will go to the municipality in which the offence took place, while the victim fine surcharge will go into the Ontario Victims' Justice Fund account.

Employers receiving a ticket have three options. An employer may plead guilty and pay the fine. The employer may plead guilty and appear in court to request a reduction in the fine. Or, an employer may plead not guilty and request a trial. ◆

Gardiner Roberts Profile:

Financial Restructuring Problem-Solvers

Directors of Canadian companies can breathe a little easier thanks to a recent ruling of the Supreme Court of Canada that they are not on the hook to creditors for decisions they make in good faith which later result in the company seeking bankruptcy protection.

The Supreme Court case involved three Québec brothers who were majority shareholders, officers and directors of Wise Stores, which had acquired Peoples Department Stores Inc. The men were also directors of Peoples. The firms suffered from problems with inventory records, so the brothers introduced an inventory procurement policy that saw one company purchase supplies for North America and another from overseas. The firms would then transfer goods to each other and charge for them.

Within a year, the firms declared bankruptcy and creditors attacked the transfers, claiming the brothers breached their fiduciary duties and negatively impacted Peoples' creditors.

A lower court allowed the claim, holding that directors have a duty not only to the corporation, but also to creditors of the corporation, "if the (corporation) is embarking on a course of action which will inevitably in the short run render it insolvent."

The brothers appealed to the Québec Court of Appeal, which overturned the ruling. The trustee then appealed to the Supreme Court of Canada, which sided with the brothers, holding that directors owe fiduciary obligations to their corporations and not to the company's creditors or any other stakeholder.

The top court ruled "the brothers implemented the policy in an honest and good faith attempt to redress the companies' financial problems. The new policy was a reasonable business decision made with a view to rectifying a serious and urgent business problem."

Until the Supreme Court ruling the case was the subject of considerable controversy in legal circles and a concern to the business community. The dispute shows the potential problems firms can face in simply trying to map out solutions to their business problems.

Our Problem-Solvers

The bottom line is that businesses need integrated solutions to business questions — solutions that mold corporate, financial and insolvency expertise into a single problem-solving strategy. That's why, at

Gardiner Roberts, we use a team approach to solving clients' financial problems.

Our growing insolvency and restructuring practice has a broad range of experts who know and understand the challenges businesses face. And, we've recently added to our bench-strength with the arrival of high-profile counsel Arthur Jacques and Vern DaRe.

Mr. Jacques has been involved in some of the most complex restructurings that Canadian businesses have faced, including Air Canada, Eaton's and Olympia & York. He has experience with both domestic and cross-border restructurings and liquidations and has been involved in international matters from England to Hong Kong.

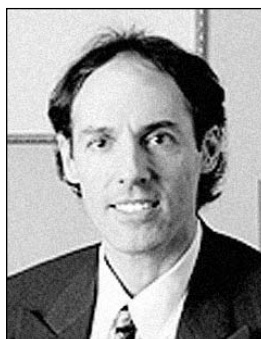
Mr. DaRe has broad experience appearing in court on behalf of receivers, trustees, monitors, secured creditors, landlords, equipment lessors, unsecured creditors and debtors in commercial reorganizations.

Their arrival complements our existing practice, which also features former Ontario Court of Appeal Justice Lloyd Houlden, who is also available to advise clients on financial restructurings, insolvency and mediation and arbitration. As the author of the leading Canadian text on bankruptcy, Mr. Justice Houlden has extensive experience in business restructurings.

Our insolvency and restructuring team works closely with our financial services and dispute resolution



Arthur Jacques



Vern DaRe

lawyers to provide clients with holistic solutions to financial problems. Businesses want lawyers who can advise them on how to resolve matters, as opposed to simply telling them what they can't do. For example, Mr. Jacques says the *Wise* case is a welcome development for corporate directors, who have been saddled with much statutory liability over the years.

The decision, he says, also shows how vulnerable directors' actions are to attack and stresses the need for businesses to call in legal counsel at the earliest stage

possible. For example, with interest rates poised to go higher, Mr. Jacques suggests now is the time for some businesses to consider restructuring operations to take advantage of lower debt costs.

As well, he warns, the rising Canadian dollar will put added pressure on all exporters. Some businesses will simply not be able to compete under their current business model should the dollar hit par with the U.S. Rather than wait for the inevitable, the time to address such a crunch is now. ◆

Gardiner Roberts News

Business Litigation Expertise Expands

Warren S. Rapoport has recently joined the firm's Dispute Resolution Practice Group as a partner, specializing in commercial, employment and pension litigation.

Warren is often sought out by executives and executive groups on employment and complex pension issues. He has significant experience successfully representing clients in partnership,



Warren S. Rapoport

shareholder and competition disputes, as well as real estate matters (including mortgage issues, appraisers' negligence, commercial leasing matters and adverse possession).

Warren has been retained by numerous multi-national corporations, as well as entrepreneurial and family businesses. He has also been retained as a mediator in commercial matters, and is an invited speaker at employment and pension law conferences. ◆

We Welcome Your Comments

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