THE UPDATE

GOODMANS
www.goodmans.ca

Corporate Restructuring

SEPTEMBER 2003

US-Canada Insolvency Proceedings - Industry Alert: Canadian Courts Showing Greater Reluctance to Rubber Stamp US Decisions when Canadian Interests at Stake

The Problem

Canada is home to hundreds of US multinational subsidiaries, so Chapter 11 bankruptcy proceedings for insolvent American entities regularly affect Canadian-based subsidiaries, their offices and assets. However, no matter how integrated the corporate structure, cross-border insolvency proceedings involve two independent legal systems. Recent trends have seen US debtors attempting to apply US law to Canadian parties and assets, with frustrating results.

Stay in Proceedings

For starters, the automatic stay in US insolvency proceedings is not automatically valid in Canada. Pursuant to section 269 of the *Bankruptcy and Insolvency Act* (Canada) ("BIA"), a foreign stay of proceedings will **not** apply to Canadian creditors with respect to Canadian property unless the stay of proceedings is sanctioned by a Canadian court. Accordingly if a US debtor wishes to protect Canadian assets, it **must** obtain a stay in Canada.

Clear Title

Second, purchasers in insolvency proceedings need to be concerned about acquiring clear title to the rights and assets they are purchasing. A buyer needs title that is enforceable as against the entire world, and needs to ensure no unknown liabilities are assumed. A Canadian court order is the *only* vehicle available to vest clear title in Canadian property.

Director Liability

Third, directors or officers of the debtor, both existing and new, may be personally liable for expansive statutory claims and personal liabilities imposed uniquely by Canadian law. These continuing obligations will not be discharged by a US Order purporting to operate without the assistance of the Canadian courts.

The Solution

Part XIII of the BIA and section 18.6 of the *Companies' Creditors Arrangement Act* ("CCAA") create a statutory framework for Canadian courts to grant comity to foreign insolvency proceedings and, in so doing, impose a complementary stay of proceedings and grant other relief. In many cases, insolvency proceedings may be commenced primarily in the United States, with ancillary proceedings taken in Canada to recognize and give effect to the primary proceeding. [1]

Comity is the recognition and deference that one jurisdiction extends within its own territory to the legislative, executive, or judicial acts – legitimately taken – of another jurisdiction with a comparable legal system, and it works. Debtors abhor dealing with multiple sets of costs –multiple proceedings can interfere with tight schedules and lead to discordant results. But deference to foreign insolvency proceedings can facilitate the distribution of a debtor's assets in an equitable, orderly, efficient and systematic manner.

[1] This is a corollary to an ancillary proceeding pursuant to Section 304 of the United States Bankruptcy Code to recognize plenary proceedings commenced in Canada.

Canadian courts have gone to great lengths to apply comity as a rule of practice, convenience and expediency when dealing with US proceedings. However, recent warnings from the bench show the Canadian courts will not be rubber stamps and that Canadian stakeholders must be given the same care, consideration and due process as those in the US.

Recent Proceedings

Two recent sets of proceedings provide very appropriate examples. The first involves divine, inc. ("Divine"), and its Canadian subsidiary, Delano Technology Corporation ("Delano").

Delano was a Canadian subsidiary of Divine whose operations had become enmeshed with both the US parent and another Canadian subsidiary that became subject to full Canadian bankruptcy proceedings (akin to Chapter 7 proceedings under the US Bankruptcy Code). Divine and a large number of subsidiaries, including Delano, filed for relief under Chapter 11 of the US Bankruptcy Code. A stalking horse auction procedure was adopted in the US bankruptcy cases, which included Canadian intellectual property and other assets of Delano.

Shortly before the auction date, and after Delano filed Chapter 11, it became apparent that: a) Delano had Canadian secured creditors; b) approximately 100 unsecured trade creditors of Delano had been omitted from the creditors' mailing list in the Chapter 11 process; and, c) a Canadian landlord was expressing an intention to exercise a lien over personal property of the debtor. While a number of the creditors of Delano had been disclosed in Delano's Chapter 11 filings, it became clear that, due internal accounting procedures, most of Delano's creditors were omitted and had not been given any notice of the Chapter 11 proceedings or the proposed auction. While Divine/Delano and their advisors were cognizant of the need for Canadian ancillary proceedings, they required the consent of the US Unsecured Creditors' Committee to fund a Canadian process. After a number of discussions, approval was finally received. Delano immediately moved to seek recognition of the US insolvency proceedings in Canada, including a stay of proceedings complementing the Chapter 11 stay and recognition of the proposed auction.

Accordingly, upon a few hours informal notice to some secured creditors and upon no notice to unsecured creditors, Delano sought and obtained an order (the "Initial Order") of the Ontario Superior Court of Justice (the "Ontario Court") pursuant to section 18.6 of the CCAA (i) recognizing the US proceedings; (ii) staying all claims against Delano in Canada; and (iii) providing for the manner of giving abridged notice of a motion to approve the US auction. In recognizing the US proceedings, the Ontario Court ordered that Canadian creditors in the Delano proceedings file their claims and objections in the US Court, rather than entertain parallel proceedings.

The Ontario Court, presided over by the Honourable Mr. Justice J.M. Farley, was highly unimpressed with the manner in which Delano's assets had been effectively appropriated and with the apparent disregard for both the Canadian process and its creditors, until the 11th hour. Nonetheless, the Ontario Court concluded that a refusal to recognize the US orders would result in a duplication of activities in the insolvency proceedings, and would not promote an orderly and efficient administration of the insolvency.

In order to satisfy the Canadian Court on short notice and with extraordinary effort, Goodmans LLP and Delano's US counsel produced a series of advertisements and notices to creditors including: newspaper ads, letters to creditors, and the filing of a notice in the Chapter 11 proceedings, requiring the amendment of Delano's Chapter 11 filings to provide for proper future notification to Canadian creditors. After satisfying considerable scrutiny, and amending the US purchase agreement to exclude all assets in Canada that were subject to secured charges and liens, Delano was able to obtain the requisite Orders of the Ontario Court to recognize the US sale approval order and to vest the key Canadian assets in the purchaser.

More recently in a case involving the failure of Recoton Canada Ltd. , the Ontario Court, again through Farley J., commented upon a request that it approve a sale of the Canadian company's assets

as part of the stalking horse bid sale process which had already been conducted and approved in U.S. proceedings involving Recoton's U.S. parent and affiliates. After leaving no one in the courtroom holding any doubt as to the degree of his judicial concern, Farley J. wrote:

> ". . . it would be prudent and respectful for the integrity of the Canadian insolvency regime and court process in the overall interests of justice for approval of the Canadian court to be sought explicitly in advance . . . rather than implicitly in arrears".

Summary

Courts must protect their sovereignty and the integrity of their statutory jurisdiction. Some courts will go further and attempt to prefer or at least protect the claims and rights of their citizens ahead of "foreigners". Canadian courts are not so parochial and have demonstrated a strong commitment to comity in recognizing the desirability of facilitating the fair, open and efficient administration of cross-border proceedings. Primarily because of the lack of statutory codification of procedures in the CCAA and BIA as compared to the U.S. Bankruptcy Code, Canadian Courts have great discretion to abridge time limits, customize notice requirements, harmonize procedures and otherwise accommodate the designs of the jurisdiction with the best basis to have overall management of multiple proceedings.

We have seen two recent warnings issued from Canada's most prominent restructuring Judge concerning the need to pay heed to the integrity of the Canadian process. If not paid due heed, the debtors, asset purchasers or directors who assume they are protected in Canada by Chapter 11 alone can expect a severe reaction in the near future. It is crucial then, in cross-border proceedings, that US practitioners act early and bring Canadian proceedings in a manner which is complementary to US proceedings rather than relegating essential cross-border protections to an afterthought.

For more information contact the following members of the Goodmans Corporate Restructuring Group:

Corporate Restructuring Group

Michele S. Altaras maltaras@goodmans.ca	416.597.4193
Maureen Bellmore mbellmore@goodmans.ca	416.597.5142
Jessica Berry jberry@goodmans.ca	416.597.4240
David Bish dbish@goodmans.ca	416.597.6276
Derek Bulas dbulas@goodmans.ca	416.597.5914
Jay A. Carfagnini jcarfagnini@goodmans.ca	416.597.4107
Robert J. Chadwick rchadwick@goodmans.ca	416.597.4285
Caterina Costa ccosta@goodmans.ca	416.597.6273
Brian Empey bempey@goodmans.ca	416.597.4194
L. Joseph Latham jlatham@goodmans.ca	416.597.4211
Geoffrey B. Morawetz gmorawetz@goodmans.ca	416.597.6278
Frederick L. Myers fmyers@goodmans.ca	416.597.5923
Joseph Pasquariello jpasquariello@goodmans.ca	416.597.4216
Gale Rubenstein grubenstein@goodmans.ca	416.597.4148
Candy Schaffel cschaffel@goodmans.ca	416.597.4153
Amy Elizabeth Vanderwal avanderwal@goodmans.ca	416.597.5909
Melaney Wagner mwagner@goodmans.ca	416.597.4258