International Secured Transactions and Insolvency

SCOTT EVERETT, THOMAS FÖRSTERLING, DANIEL MARIN, JUAN PABLO SCHWENCKE, MAX MENDELSOHN, ANDREW KENT, NICK SCHEIB AND KIRIAKOULA HATZIKIRIAKOS*

Section I of this article addresses two judicial opinions of note that were rendered during the review period, the first by the U.S. Eleventh Circuit Court of Appeals and the second by the European Court of Justice. Section II of this article addresses developments in insolvency law occurring during the coverage period in Germany, Spain, and Chile.

I. Recent Decisions

A. COMITY GRANTED TO KOREAN INSOLVENCY PROCEEDING; COLLATERAL ATTACK IN UNITED STATES TO CONFIRMED PLAN HALTED

In *Daewoo Motor America, Inc. v. General Motors Corp.*,[1] the Eleventh Circuit Court of Appeals affirmed the lower court's decision to dismiss,[2] on international comity grounds, claims of a Chapter 11 automobile distributor that collaterally attacked the confirmed reorganization plan of its parent auto manufacturer in Korea.

Daewoo America was the sole U.S. distributor of Daewoo automobiles manufactured by its Korean parent company, Daewoo Korea. In November 2000, Daewoo Korea filed for bankruptcy protection under the Korean Corporate Reorganization Act. Daewoo America retained Korean bankruptcy counsel, filed claims against Daewoo Korea's bank-

* The sections concerning the *Eurofood* decision and developments in German insolvency law were contributed by Thomas Försterling, who is a founding Partner of SALGER Rechtsanwälte, Frankfurt, Germany. The section concerning recent changes in Chilean insolvency procedure was contributed by Juan Pablo Schwencke, a founding Partner of Aninat Schwencke & Cia, Santiago de Chile. The section regarding statutory reform of insolvency legislation in Canada was contributed by Max Mendelsohn, Andrew Kent, Nick Scheib, and Kiriakoula Hatzikiriakos, who are all with McMillan Binch Mendelsohn LLP: Max Mendelsohn is Chair of the Board of Partners and a partner in the Debt Products and Restructuring practice group; Andrew Kent is Chief Executive Officer and Chair of the Debt Products and Restructuring practice group; Nick Scheib is with the Debts Products and Restructuring group; and Kiriakoula Hatzikiriakos is a partner in the Debt Products group. Daniel Marin, who is a Senior Associate Lawyer in the Barcelona, Spain, office of Gomez-Acebo & Pombo, prepared the section regarding developments in Spain. Scott Everett, who is a Partner in the Dallas, Texas, office of Haynes and Boone, LLP, also contributed to this article.

1. Daewoo Motor America, Inc. v. General Motors Corp., 459 F.3d 1249 (11th Cir. 2006).
2. Daewoo Motor America, Inc. v. General Motors Corp., 315 B.R. 148 (M.D. Fla. 2004).

ruptcy estate, and actively participated in the Korean proceeding. Daewoo Korea's court-appointed receiver negotiated a sale of the company's assets, including its manufacturing facilities, to an affiliate of General Motors (GM) and also requested court authority to terminate its distribution agreement with Daewoo America. The Korean court approved the termination of the distribution agreement in May 2002 and also approved the sale to GM pursuant to a reorganization plan that was confirmed in September 2002. Daewoo America did not object to that reorganization plan.

Daewoo America filed its own bankruptcy case in the Central District of California in May 2002, threatening to sue GM and others if GM were to start selling Daewoo cars in the United States. When GM and its U.S. affiliate, American Suzuki, started selling Daewoos under the Chevrolet and Suzuki brands, Daewoo America sued them in bankruptcy court for violation of the automatic stay and for a laundry-list of contract and tort claims. The suit was transferred to the Middle District of Florida for consolidated pretrial proceedings related to Daewoo, and the district court there dismissed the suit on grounds of international comity.[3]

Comity is "the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws."[4] Although motions to dismiss are usually reviewed *de novo*, the Eleventh Circuit applied a more lenient abuse-of-discretion standard because dismissal on comity grounds is a form of abstention.[5]

The Eleventh Circuit affirmed the decision to dismiss, concluding that the district court did not abuse its discretion in concluding that: (a) Korea's interest in regulating business activities on its shores outweighed any prejudice to Daewoo America; (b) Daewoo America had adequate notice of the Korean proceeding and had a full and fair opportunity to participate in that proceeding; and (c) Daewoo America's claims against GM arose out of the same operative facts considered by the Korean court, and Daewoo America should have addressed the propriety of the sale in that proceeding rather than collaterally attacking the Korean reorganization plan in the Unites States.[6]

B. Eurofood Decision Resolves "Center of Main Interest" Dispute

Probably the most important judgment rendered on insolvency in Europe in 2006 was the *Eurofood* decision of the European Court of Justice.[7]

Eurofood was an Irish company registered in Dublin as a wholly owned subsidiary of Parmalat S.p.A. (Italy). It was created to finance facilities for the Parmalat group. On December 24, 2003, Parmalat was declared insolvent, and a receiver was instituted in Italy. Thereafter, a U.S. bank sought and obtained the liquidation of Eurofood in Ireland, and on January 27, 2004, the High Court of Ireland appointed a receiver as the provisional liquidator of the company, granting him the power to take possession of Eurofood's assets.

3. *Id.* at 160.
4. Daewoo Motor America, 459 F.3d at 1257-58 (quoting Hilton v. Guyot, 159 U.S. 113, 164 (1895)).
5. *Id.* at 1256.
6. *Id.* at 1258-59.
7. Case C-341/04, Re Eurofood IFSC Ltd., 2006 E.C.R. 1078.

On February 9, 2004, Eurofood was placed under the extraordinary administration of another receiver in Italy, and on February 10, 2004, the Italian Court of Parma appointed a receiver. It simultaneously held that the main economic interests of Eurofood were in Italy and that therefore the Italian courts had jurisdiction over the assets of the Irish company.

The Irish courts, however, held that they had jurisdiction and that the center of Eurofood's interests was not in Italy but in Ireland. The High Court of Ireland, therefore, submitted the case to the European Court of Justice for a ruling on the conflict. The Court of Justice ruled as follows:

- According to Community rules, the court with jurisdiction to open the main insolvency proceedings applying to the debtor's assets situated in all the Community is the court of the Member State where the center of the debtor's main interests is situated.[8]
- The center of the main interests of the debtor's company is presumed to be the place of the registered office where the debtor regularly administered its interests.[9] That presumption can be rebutted only if factors that are both objective and ascertainable by third parties establish otherwise.[10] Therefore, when a company carries on its business in the territory of the Member State where its registered office is situated, the mere fact that its economic choices are or can be controlled by a parent company in another Member State is not enough to rebut the presumption linked to the place of the registered office.[11] As the Court of Justice put it:

  > [T]he rule of priority laid down in Article 16(1) of the Regulation, which provides that insolvency proceedings opened in one Member State are to be recognised in all the Member States from the time that they produce their effects in the State of the opening of proceedings, is based on the principle of mutual trust. It is that mutual trust which has enabled a compulsory system of jurisdiction to be established, which all the courts within the purview of the Convention are required to respect, and as a corollary the waiver by those States of the right to apply their internal rules on recognition and enforcement of foreign judgments in favour of a simplified mechanism for the recognition and enforcement of decisions handed down in the context of insolvency proceedings. It is inherent in that principle of mutual trust that the court of a Member State hearing an application for the opening of main insolvency proceedings check that it has jurisdiction. . ., i.e. examine whether the centre of the debtor's main interests is situated in that Member State. . . . In return, as the 22nd recital of the Regulation makes clear, the principle of mutual trust requires that the courts of the other Member States recognise the decision opening main insolvency proceedings, without being able to review the assessment made by the first court as to its jurisdiction.[12]

8. *Id.* ¶ 28.

9. *Id.* ¶ 29.

10. *Id.* ¶¶ 33-34. (The actual wording of the court was: "enabled to be established that an actual situation exists which is different from that which locating it at that registered office is deemed to reflect.")

11. *Id.* ¶¶ 36-37.

12. *Id.* ¶¶ 39-42 (citations omitted).

However, a Member State may refuse to recognize insolvency proceedings opened in another Member State where the decision to open the proceedings was taken in flagrant breach of the fundamental right to be heard which a person concerned by such proceedings enjoys.[13]

II. Developments in Germany, Spain, Chile, and Canada

A. Notes on Insolvency Law Developments in Germany

Two significant developments regarding insolvency law in Germany, which may be of practical interest to foreign readers, occurred in 2006:

1. *Direct Debit Mandate*

In commercial relationships between parties, payment on delivery is very often replaced by so-called direct debit mandate (*Einziehungsermächtigung*) by which the vendor is authorized to directly debit the account of the purchaser within a certain time after delivery of the purchased product. Once the purchaser is informed through his bank that the vendor has debited his bank account, the purchaser has a notice period of six weeks during which he may inform the bank that it rejects the debit note in his bank account. In this context, the German Federal Court of Justice has ruled that, in such cases, the insolvency receiver may instruct the bank to oppose itself to the debit note in the account within the six weeks' period, even if there are no objective grounds that the debit note might not be justified.[14] The mere fact that there is an insolvency procedure authorizes the insolvency receiver to withdraw all the debit notes within the time frame.

The Federal Court of Justice's decision has been heavily criticized for mainly two reasons.[15] First, as a consequence of the decision, the insolvency receiver is now practically required to oppose all of the debtor's bank debit notes and, secondly, the beneficiaries of such debit notes can no longer be assured of their payments unless the six-week period has expired. As a result, vendors have become hesitant to accept this kind of payment instead of payment on delivery.

2. *German Insolvency Law Applicable to Foreign Corporations Established in Germany*

Several decisions of the European Court of Justice allow corporations incorporated in a country of the European Union to conduct their activities in another country pursuant to the principle of the freedom of establishment.[16] As a result, for example, "limited companies" established in the United Kingdom may, once established there, transfer their activi-

13. *Id.* ¶ 67.

14. Bundesgerichtshof [BGH] [Federal Court of Justice] Nov. 4, 2004; 10 Neue Juristische Wochenschrift 675 (2005).

15. *See* Carsten Jungmann, *Grenzen des Widerspruchsrechts des Insolvenzverwalters beim Einzugsermächtigungsverfahren*, 2005 Neue Zeitschrift fuer das Recht der Insolvenz und Sanierung 84; Gerhard Ganter, *Die Rechtsprechung des Bundesgerichtshofs zum Insolvenzrecht im Jahr 2004*, 2005 Neue Zeitschrift fuer das Recht der Insolvenz und Sanierung 241.

16. Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 2000 E.C.R. 481.; Case C-208/00, Überseering BV v. Nordic Constr. Co. Baumanagement GmbH, 2002 E.C.R I-09919; Case C-167/01, Kamer van Koophandel v. Inspire Art Ltd., 2003 E.C.R. I-10155.

ties to Germany and exercise their activities exclusively there, while remaining established in the United Kingdom and subject to that country's corporate rules. This has become a popular business model for many companies for the simple reason that establishing such limited companies in the United Kingdom is much less costly than establishing the equivalent type of company in Germany, the so-called *Gesellschaft mit beschränkter Haftung* (limited company by shares).

Against this background, in 2006 several German courts were called upon to decide whether or not German insolvency law is applicable to such companies, and, in particular, to the company directors who, under German law, have an obligation to file an insolvency petition within three weeks of discovering, or being in a position to discover, that their company is insolvent. Such rules do not exist in the United Kingdom; to be more precise, the rules under which petitions for insolvency must or may be made in the United Kingdom are different from German insolvency legislation. The conclusion of the German courts is that German insolvency law applies to such directors, regardless of the fact that the company has been established in the United Kingdom and is subject as to its internal organization to English law.[17] As a result, in practice the attractiveness of a limited company as a legal form for commercial activity in Germany has greatly diminished.

B. SPAIN

1. *New Regulations Regarding in Rem Guarantees*

In 2006, the Regional Government of Catalonia passed a new law regarding *in rem* rights.[18] This law, among other provisions, contains a new regulation of pledges and certain types of mortgages. The law is important, not only because of the economic importance of Catalonia, but because it regulates in greater detail than any other laws in force in Spain and therefore sheds some light on the validity of certain types of guarantees. Thus, for example, the law makes clear that with respect to pledges over a portfolio of shares, the seniority of the pledge is maintained even if the shares of the portfolio change.[19] The Catalonian law also illustrates the importance of being aware of the regional, and in some cases local, regulations when dealing with legal issues in Spain.

2. *Proposed Law on the Priority of Debts Executed Outside Insolvency Proceedings*

Congress and parliament are considering a modification to the Spanish Civil Code to deal with the priority of debts executed outside of an insolvency proceeding in cases in which several creditors are executing against the same assets.[20] The regulation under con-

17. Landgericht Kiel [LG Kiel] [Kiel Trial Court] Apr. 20, 2006, 8 NEUE ZEITSCHRIFT FUER DAS RECHT DER INSOLVENZ UND SANIERUNG 482 (2006).

18. Law 5/2006 of May 10, 2006 (Spain), El Libro Quinto del Código Civil de Cataluña, relativo a los derechos reales [Book Five of the Civil Code of Catalonia regarding *in rem* rights], B.O.E. [Official Gazette] 2006, 148, *available at* http://www.boe.es/boe/dias/2006/06/22/pdfs/A23543-23595.pdf.

19. *Id.* at arts. 569-12, 569-17.

20. Proyecto de Ley sobre concurrencia y prelación de créditos en caso de ejecuciones singulares [Project of Law on concurrence and priority of debts executed outside insolvency proceedings], passed by the Cabinet on July 21, 2006, and submitted to Congress for its review, amendment, and approval on July 26, 2006. This project of law is being debated in Congress, *available at* http://www.congreso.es/public_oficiales/L8/CONG/BOCG/A/A_098-01.PDF.

sideration would coordinate the priority of debts in executions against particular assets with provisions governing the priority of debts in executions against the total assets of a natural person or a company in an insolvency proceeding, which were modified by the new insolvency law in force since 2004.[21]

C. Recent Changes in Chilean Insolvency Procedures

In 2005, the Chilean government enacted legislation to reform the country's insolvency system.[22] These laws were designed to impose stricter regulations regarding trustees, strengthen the power of the Superintendent of Bankruptcy, enhance transparency, encourage agreements prior to liquidation, and create a more efficient bankruptcy process in general.[23] Given the large amount of foreign investment in Chilean companies, these reforms should be of interest beyond Chile. In addition, these changes have broad implications because "[a]n effective insolvency and creditor rights system plays an important role in creating and maintaining the confidence of both domestic and foreign investors."[24]

One of these newly enacted laws, Law No. 20,073,[25] which went into effect on November 29, 2005, is designed to facilitate agreements between debtors and creditors both before and during bankruptcy proceedings in order to avoid liquidation.[26] The changes implemented by Law No. 20,073 are important for several reasons, including the emphasis on preserving businesses in lieu of liquidation and the incorporation of alternate dispute resolution mechanisms into insolvency proceedings. Both of these changes reflect Chile's perception and adoption of global insolvency trends.

There were several key problems with the insolvency procedures in place prior to the new legislation,[27] including the fact that the bankruptcy law did not explicitly contemplate the goal of preserving businesses with financial problems when viable.[28] The insolvency system instead was focused on the prompt and efficient liquidation of a debtor's assets for the purpose of the equitable payment of the creditors. In sophisticated insolvency systems in place in other countries, such as in the United States, Mexico, and France, there is a

21. Law 22/2003 of July 9, 2003 (insolvency) (Spain).

22. The first of these laws is Law No. 20,004 of Feb. 25, 2005, Diario Oficial [D.O.], Mar. 8, 2005. The second is Law No. 20,073 of Nov. 14, 2005, Diario Oficial [D.O.], Nov. 29, 2005, which will be discussed in further detail below. Both of these laws are amendments to the Bankruptcy Law, which is codified as Law No. 18,175 of Oct. 13, 1982, Diario Official [D.O.], Oct. 28, 1982.

23. Law No. 20,004 of Feb. 25, 2005, Diario Oficial [D.O.], Mar. 8, 2005; Law No. 20,073 of Nov. 14, 2005, Diario Oficial [D.O.], Nov. 29, 2005.

24. World Bank, Report on Observance of Standards & Codes: Chile, Insolvency and Creditor Rights Systems 3, (2004), *available at* http://www.worldbank.org/ifa/rosc_icr_chl.pdf.

25. Law No. 20,073 of Nov. 14, 2005, Diario Oficial [D.O.], Nov. 29, 2005, is an amendment to the general Bankruptcy Law, which is codified as Law No. 18,175 of Oct. 13, 1982, Diario Oficial [D.O.], Oct. 28, 1982.

26. *See generally* Paulo Larrain & Gonzalo Cordero, *Amendments to Chilean Bankruptcy Law: Creditors' Agreements*, 13 Latin Am. Law & Bus. Rep. 22, 23 (2005).

27. Several lawyers and economists conducted a thorough analysis of the Chilean insolvency system, and they published their findings and recommendations in September 2003. *See* Claudio Bonilla et al., Análisis y Recomendaciones para una Reforma de la Ley de Quiebras (2003), *available at* www.webmanager.cl/prontus_cea/cea_2004/site/asocfile/ASOCFILE120040719113315.pdf.

28. *Id.* at 4.

clear emphasis on preserving businesses.[29] In contrast, the Chilean legislation did not provide sufficient incentives for debtors to reach agreements with creditors in order to avoid the liquidation of businesses.[30] It is true that the Bankruptcy Law permitted both pre-bankruptcy agreements (preventive judicial agreements) and agreements reached during bankruptcy proceedings (judicial agreements);[31] however, the law did not provide mechanisms to encourage parties to reach such agreements.[32] In addition, Chile lacked sufficiently specialized courts and expedited procedures for resolving insolvency matters.[33]

Although the legislators did not fully correct all of these problems in accordance with modern trends,[34] Law No. 20,073 includes certain provisions that respond to the shortcomings of the previous system. For example, one of the central aspects of Law No. 20,073 is its creation of an "expert facilitator," who is appointed by the creditors meeting upon the debtor's request to the court and who is subject to the supervision of the Superintendent of Bankruptcy.[35] This new position was modeled in part on the French insolvency system, in which a conciliator is appointed specifically to encourage "extrajudicial friendly agreements."[36] The expert facilitator is selected by the vote of one or more creditors representing more than 50 percent of the total liabilities with the right to vote.[37]

After his or her appointment, the expert facilitator must evaluate the debtor's legal, accounting, and financial situation and propose a preventive judicial agreement that is more advantageous than bankruptcy.[38] The law provides the expert facilitator with a term of thirty days in which to accomplish this.[39] A preventive judicial agreement can encompass a broad range of issues and possible solutions, as Law 20,073 states that it may include any lawful provision that will help to avoid bankruptcy with the exception of an alteration of the amount of credit fixed for the determination of liability.[40] In addition, a preventive judicial agreement may include both a principal proposal and alternative proposals for the creditors to select.[41] Such proposed preventive judicial agreement will be approved upon the consent of the debtor and the vote of at least two-thirds of the creditors representing three-quarters of the total liabilities who have the right to vote.[42] If a preventive judicial agreement would not be advantageous in the opinion of the expert

29. *Id.* at 23-24, 61. The study points out, for example, that Chapter 11 of the U.S. Bankruptcy Code is clearly favorable to debtors and provides troubled businesses with the opportunity to reorganize rather than to cease doing business. *Id.* at 23.

30. *Id.* at 5.

31. *Id.* at 53.

32. *Id.* at 5.

33. *Id.* at 11-12.

34. For example, the authors of the study cited in note 27 suggested including a new introductory statement of the goals of the bankruptcy system, and the legislators did not include such language. BONILLA, *supra* note 27, at 4-5.

35. Law 20,073 of Nov. 14, 2005, Diario Oficial [D.O.], Nov. 29, 2005, at art. 177 *ter.*

36. BONILLA, *supra* note 27, at 5-6.

37. Law 20,073 of Nov. 14, 2005, Diario Oficial [D.O.], Nov. 29, 2005, at art. 177 *ter.*

38. *Id.*

39. *Id.*

40. *Id.* art. 178.

41. *Id.*

42. *Id.* art. 190.

facilitator, then he or she will request that the court initiate bankruptcy proceedings.[43] The new legislation requires the debtor to pay the expert facilitator's fees.[44]

There have been some criticisms of the provisions set forth in Law No. 20,073 regarding the expert facilitator, including the fact that he or she has only thirty days in which to both evaluate the company and propose a preventive judicial agreement (or to conclude that such an agreement is not feasible).[45] There is an inherent tension in the expert facilitator's dual position as evaluator of the debtor and mediator between the parties. In addition, the law contains no requirements regarding the qualifications or experience of an expert facilitator,[46] other than stating that the expert facilitator must have the capacity to administer his or her own assets.[47]

Another key change implemented by Law No. 20,073 is the requirement in the case of corporations subject to the control of the Superintendent of Securities and Insurance[48] that a proposed preventive judicial agreement be submitted for arbitration.[49] Some experts recommended creating specialized economic or bankruptcy courts to handle insolvency matters,[50] but the legislature chose not to create such new courts and simply to implement arbitration. The new legislation specifies that a single arbitrator will be appointed by the relevant Court of Appeals,[51] and he or she will have the authority to process all of the propositions of the relevant preventive judicial agreement.[52] The arbitrator has the right to access all records as well as to require the parties to produce evidence in the proceedings as he or she believes it to be necessary.[53] The arbitrator is required to set forth his or her rationale for reaching his or her conclusions.[54] As with the expert facilitator, the debtor is responsible for the costs of arbitration.[55]

As pointed out above, various critics have pointed out the problems with Law No. 20,073, which is likely insufficient to adequately address the issues identified by experts in such matters. However, Law No. 20,073 is nonetheless a step toward improving the sys-

43. *Id.* art. 177 *ter.*

44. *Id.*

45. Paola Rocca Mattar, *Seminario, Los Convenios: "Alternativa para superar la crisis de la Empresa,"* http://www.camvalpo.cl/articulo_seminario_ley%20de%20quiebra.htm (last visited Mar. 18, 2007); Jorge Lembeye Valdivia, *El Experto Facilitador y la Viabilidad de la Empresa*, http://www.camvalpo.cl/experto_facilitador.pdf (last visited Mar. 18, 2007).

46. *Id.*

47. Law 20,073 of Nov. 14, 2005, Diario Oficial [D.O.], Nov. 29, 2005, at art. 177 *ter.*

48. All publicly-traded corporations are required to register with the Superintendency of Securities and Insurance, but other corporations also have the option to voluntarily register with the Superintendency. Law No. 18,045 of Oct. 21, 1981, Title II, Diario Oficial [D.O.], Oct. 22, 1981.

49. Law 20,073 of Nov. 14, 2005, Diario Oficial [D.O.], Nov. 29, 2005, at art. 180. This article specifies that insurance companies are exempt from the arbitration requirement.

50. BONILLA, *supra* note 27, at 11-12.

51. Law 20,073 of Nov. 14, 2005, Diario Oficial [D.O.], Nov. 29, 2005, at art. 181.

52. *Id.* art. 180. Article 182 specifies that the parties may use an *árbitro mixto* upon the consent of the debtor and of two or more creditors representing more than 50 percent of the total liabilities in the case of corporations subject to the supervision of the Superintendency of Securities and Insurance or 75 percent in all other cases. An *árbitro mixto* has the authority to rely on equitable principles and to conduct the proceedings with greater procedural flexibility than an *árbitro de derecho.* Codigo Organico de Tribunales, Title IX, art. 223.

53. Law 20,073 of Nov. 14, 2005, Diario Oficial [D.O.], Nov. 29, 2005, at art. 185, part 1.

54. *Id.* at art. 185, part 2.

55. *Id.* at art. 183.

tem's shortcomings. Prior to the new laws, Chilean bankruptcy legislation did not sufficiently emphasize the importance of avoiding insolvency proceedings and subsequent liquidations. The legal and academic community has acknowledged that the intent of Law No. 20,073 is to provide alternatives to bankruptcy in order to save businesses that are struggling,[56] and the law has been presented to the general public in this light as well.[57] Thus, even if there are shortcomings in the procedural details of the law as written, these reforms represent a major shift in the Chilean government's view of the purposes of the national insolvency system.

In addition, the implementation of both mediation (through the figure of the expert facilitator) and arbitration is an acknowledgment by the legislature of the benefits and increasing use of alternative dispute mechanisms in various insolvency systems.[58] Justice Rosa María Maggi Ducommun of the Court of Appeals in Santiago recently discussed the recent changes in the law at an international conference. She noted the shift in attitude away from litigation and liquidation and toward settlement and corporate restructuring, which paved the way for the use of alternative dispute resolution in bankruptcy proceedings.[59] She asserted that insolvency matters are particularly amenable to alternative means of dispute resolution because all of the relevant issues are subject to negotiation, and the parties will typically be accustomed to the process of negotiation.[60] It is too soon to observe whether the changes discussed in this article will indeed bring about a more efficient insolvency process, but it is clear that there is still much to be done. Nonetheless, these reforms indicate a crucial willingness to change and to continue the process of updating the insolvency system.

D. Statutory Reform of Insolvency Legislation in Canada

1. *Movements Toward Insolvency Legislation Reform*

Over the past several years, the Government of Canada conducted a statutorily mandated review of the Canadian insolvency system, which included extensive consultation with a number of representative groups. This process has not yet resulted in definitive, fully enacted legislative amendments to Canada's principal insolvency statutes. Rather,

56. The Centro de Arbitraje y Mediación V Región hosted a conference on the topic of "Agreements: 'Alternatives to Overcome Business Crises.'" One of the participants noted that the "spirit of the law" is to save businesses by means of the relevant agreements. Mattar, *supra* note 45.

57. A leading Chilean newspaper, El Mercurio, published an article about the changes in the bankruptcy legislation entitled "Para evitar la quiebra de empresas" ("To avoid bankruptcies of businesses"). An excerpt of this article is available at http://www.camvalpo.cl/leyquiebra_mercurio.htm (last visited Mar. 17, 2007).

58. *See* Central European and Eurasian Law Initiative, Legislative Assistance and Research Program, Alternative Dispute Resolution in Bankruptcy: A Concept Paper 1 (2000), *available at* http://www.abanet.org/ceeli/publications/conceptpapers/adrbankruptcy/adr_bankruptcy_concept_paper.pdf ("The use of alternative dispute resolution methods in bankruptcy matters continues to proliferate."). For example, the use of alternative dispute resolution in the U.S. Bankruptcy Courts is expanding each year. Global Judges Forum, Working Group Session: LAC 2006, Summary Report (2006), *available at* http://siteresources.worldbank.org/GILD/Resources/GJF2006SummaryReportEN.pdf.

59. Global Judges Forum, *supra* note 58.

60. *Id.*

there are two amending bills that seek to codify reform but which very well may not be the last word on changes to Canada's insolvency system.[61]

The purpose of this section of the article is to describe the context of the recent insolvency reform initiatives in Canada and to summarize the main features of the proposed amendments. This most recent initiative (the 2006 Proposed Amendment) comes in the form of the proposed legislation attached to the Notice of Ways and Means Motion to introduce an Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act, and Chapter 47 of the Statutes of Canada, 2005.[62]

2. *Recent History of Canadian Insolvency Reform: Proposed Amendments*

Canada has two principal statutes governing insolvency matters, namely the Bankruptcy and Insolvency Act (BIA)[63] and the Companies Creditors' Arrangements Act (CCAA)[64]. In November 2005, on the eve of its dissolution preceding a general election, Canada's Parliament (consisting of Canada's two legislative houses), under the governance of a Liberal Party-led minority government, passed legislation (the 2005 Proposed Amendment)[65] designed to amend the BIA and the CCAA. The 2005 Proposed Amendment was passed in haste in the midst of consultation and analysis of draft legislation which had given rise to considerable substantial and technical concerns and comments. In recognition of this situation, and at the urging of the Canadian Senate (one of the houses of Parliament), the 2005 Proposed Amendment provided that its proclamation into force would be deferred until June 30, 2006,[66] in order to allow the completion of the analysis process and any possible amendments.

A general election in January 2006 gave rise to a change of government, with the Conservative Party assuming leadership of a new minority government. The 2005 Proposed Amendment was not proclaimed into force by June 2006. Rather, the 2005 Proposed

61. This is largely because passing these bills and proclaiming them into force does not appear to be a top priority of the minority governments in Canada in the last two years.

62. Canadian Minister of Labour, Motion to introduce an Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act, and Chapter 47 of the Statutes of Canada, Sess. Papers 8570-391-16, Dec. 8, 2006 [hereinafter 2006 Proposed Amendment]. The proposed legislation is not yet in the form of a stand-alone bill, but rather is an adjunct to the above-described "ways and means motion" (which motions are a procedural vehicle usually used for introducing tax and spending initiatives).

63. Bankruptcy and Insolvency Act, R.S.C., ch. B-3 (1985) [hereinafter BIA].

64. Companies Creditors' Arrangements Act, R.S.C., ch. C-36 (1985) [hereinafter CCAA]. Note that in addition to the BIA and the CCAA, Canada also has a number of provincially-enacted statutes that address property and civil rights matters that are of relevance to insolvency matters. Given the ambit of this section of the article, it is not possible to give a proper overview of the interplay between the BIA and CCAA, on the one hand, and the various provincial statutes that affect insolvency matters in Canada. Please see MAX MENDELSOHN ET AL., COUNTRY Q&A, CANADA: RESTRUCTURING AND INSOLVENCY (2006), *available at* http://www.mcmbm.com/Upload/Publication/MMendelsohn_JGollob_AMaerov_MMorin_NScheib_PLCRestructuring_2006-07.pdf; *see also* http://www.practicallaw.com/6-202-1026, for relevant publications in this respect.

65. Bill C-55, An Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts, 1st Sess., 38th Parl. (2005) (assented to Nov. 25, 2005) [hereinafter 2005 Proposed Amendment].

66. *Id.* § 141.

Amendment (along with the underlying legislation it sought to amend, namely the BIA and the CCAA) became the subject of further proposed reform in the guise of the 2006 Proposed Amendment. Considering that it appears likely that Parliament may imminently be dissolved once again pending a new election, it is possible that the 2006 Proposed Amendment will also be left in limbo due to the political context in which it arose.[67]

3. *The Reasons for Reform*

While there is uncertainty as to the final form and timing of legislative amendment to the BIA and CCAA, one of the main thrusts behind recent Canadian insolvency reform has been a desire to bring more consistency to the process by codifying some of the solutions developed by the courts and making them accessible in smaller restructurings. This theme will undoubtedly be reflected in whatever legislation is finally enacted.

To date, much of the law applicable to larger restructurings has been developed on a case-by-case basis by the Canadian bankruptcy courts. The courts' approach has often been praised for its flexibility and responsiveness to the needs of the business community but criticized for its lack of predictability. This flexible approach flows from the sparsely drafted, Depression-era CCAA. The CCAA has been used extensively by courts since the early 1980s to develop a comprehensive, albeit fluid, body of rules with a view to addressing the ever-evolving needs of distressed debtors and their stakeholders. The CCAA applies only to restructurings involving more than CAD$5,000,000 in debt.[68]

Restructurings of a lesser magnitude, and some larger ones, are conducted under the BIA. The BIA process is simpler and usually quicker but has lacked the flexibility inherent to the CCAA. Indeed, the BIA's reorganization regime in its current form contemplates a little more than the compromise of debt.[69] As a result, the solutions developed by the courts under the CCAA are generally not apt to be imported under BIA proceedings.

4. *Changes Proposed*

The following is a review of the aggregate of the proposed changes to the BIA and the CCAA found in the 2006 Proposed Amendment and the (otherwise unamended) 2005 Proposed Amendment (which we will refer to collectively as the Proposed Amendments).

Four major themes emerge from the Proposed Amendments. First, they would provide greater protection for wages in insolvency through a government fund.[70] Second, the Proposed Amendments would codify a number of the innovations that have developed through caselaw in CCAA cases over the last twenty years. Third, they would introduce a

67. The 2006 Amendment is subject to abandonment in the event that Parliament is dissolved pending another general election. *See* http://www.theglobeandmail.com/servlet/story/RTGAM.20070221.wbudget21/BNStory/National/home.

68. CCAA, *supra* note 64, § 3(1).

69. *See generally* BIA, *supra* note 63, §§ 50-66.

70. 2005 Proposed Amendment, *supra* note 65, § 1, art. 35. Note that the 2005 Proposed Amendment includes 141 sections. Section 1 includes 42 articles that collectively constitute the Wage Earner Protection Program Act, 2005 S.C., ch. 47. Sections 2 to 123 of the 2005 Proposed Amendment are the proposed changes to certain sections of the BIA, while Sections 124 to 131 constitute proposed amendments to the CCAA. The remaining sections of the 2005 Proposed Amendment include transitional provisions, consequential amendments to other legislation, a coordinating amendment, and the provision on the (yet to materialize) coming into force of the 2005 Proposed Amendment.

number of innovations, marking a significant evolution from the existing law and practice. And fourth, the Proposed Amendments would harmonize to a large extent the restructuring provisions of the BIA and the CCAA, thereby broadening the scope of what can be accomplished under the BIA to bring it more in line with CCAA practice. This harmonization ranges from permitting a debtor to disclaim a broad spectrum of executory contracts to facilitating debtor-in-possession (DIP) financing and other substantial debtor relief to date available only under the CCAA's restructuring system, as discussed in detail and referenced below.

The most notable aspects of the impetus to reform embodied in the Proposed Amendments can be summarized as follows.

a. Labor and Employee Issues

Much of the impetus behind reform of Canadian insolvency legislation to date relates to a perceived need to improve the fate of current and former employees of insolvent enterprises. To that end, a government-financed fund would be created to pay unpaid prefiling wages, within specified limits.[71] To protect the fund, the Proposed Amendments would alter the existing rank afforded claims by employees in bankruptcy situations.[72] Employee claims in respect of unpaid wages and vacation pay (of up to a maximum of $2,000 earned up to six months prior to a bankruptcy) would benefit from a first-ranking charge over the "current assets" of the debtor.[73] The immediate repayment of such claims (up to a maximum of $2,000) would have to be provided for in any BIA or CCAA plan of restructuring.[74]

According to the changes contemplated by the Proposed Amendments, the BIA and CCAA would also specify that certain pension contributions due as of an initial stay order (akin to what are known in the United States as "first day orders") must be remedied in any restructuring plan[75], and claims based thereon are accorded a new charge with superpriority status[76]. This charge extends to all of the debtor's assets.[77] It has been said to be the intention that the provisions relate only to current service pension contributions and not the debtor's obligations to cover going concerns or insolvency deficiencies, but the text of the Proposed Amendments is somewhat ambiguous in this regard.[78]

71. 2005 Proposed Amendment, *supra* note 65, § 1, art. 35.

72. *See generally* the current form of BIA, *supra* note 63, § 136(1)(d), which renders employees' wage claims subject to the priority of secured creditors, albeit with a priority over certain other unsecured claims. 2006 Proposed Amendment, *supra* note 62, § 38, would add new Sections 81.3 and 81.4 to the BIA, *supra* note 63, giving such employee wage claims a secured status in bankruptcy and receivership contexts.

73. 2006 Proposed Amendment, *supra* note 62, § 38, which would add new Sections 81.3 and 81.4 to the BIA, *supra* note 63.

74. 2005 Proposed Amendment, *supra* note 65, §§ 39(1) (which would replace BIA, *supra* note 63, § 60(1.3)(a)), and 126 (which would add a new Section 6(4) to the CCAA, *supra* note 64).

75. 2005 Proposed Amendment, *supra* note 65, §§ 39 (which would add Sections 60(1.5) and 60(1.6) to the BIA), and 126 (which would add new Sections 6(5) and 6(6) to the CCAA, *supra* note 64).

76. 2005 Proposed Amendment, *supra* note 65, § 67 (which would add Section 81.5(2) to the BIA, *supra* note 63).

77. 2005 Proposed Amendment, *supra* note 65, § 67 (which would add Section 81.5(1) to the BIA, *supra* note 63).

78. *See* 2005 Proposed Amendment, *supra* note 65, § 67, regarding the new Sections 81.5(1)(a),(b), and (c) of the BIA, *supra* note 63.

The proposed creation of these two new priority charges has provoked fears that they could give rise to more restrictive lending practices. It will be interesting to see whether any new amending legislation or modifications to the 2006 Proposed Amendment address these fears.

b. DIP Financing

DIP financing is an area in which existing insolvency practice is sought to be codified under the Proposed Amendments. Even though DIP financing has been a feature of Canadian CCAA-based restructuring practice for a number of years, it had no clear statutory basis.[79] The Proposed Amendments would provide the first statutory codification of this facility in the CCAA[80] and extend the possibility of DIP financing to BIA restructurings.[81]. Under this reform, courts would be empowered to grant fresh security over a debtor's assets to DIP lenders under both BIA and CCAA restructurings.[82] Consistent with current CCAA practice, the court would have the ability to determine that the DIP security trumps the priorities accorded to existing security interests.[83]

There are several enumerated criteria that the courts must consider prior to authorizing DIP financing. These provisions seek to ensure that DIP financing is permitted judiciously and does not unduly prejudice parties. Under Canadian insolvency, there is no concept closely analogous to a requirement of "adequate protection." This is an area in which Canadian DIP financing law is, and is likely to continue to be, more debtor-friendly than U.S. law.

c. Other Special Restructuring Priority Charges

In addition to DIP financing, the Proposed Amendments would codify other special restructuring priority charges that have been introduced over time by the CCAA-based caselaw but have yet to be given a statutory basis. For example, discretion would be given to a court to order a special charge for the debtor's financial, legal, and other experts' costs.[84] The court may also authorize security for the costs of court-appointed officials such as trustees, interim receivers, and receiver-managers,[85] as well as for the indemnification obligations in favor of directors[86] for post-filing liabilities. In addition, the Proposed Amendments would be innovative in permitting a court to authorize security for the costs

79. CCAA, *supra* note 64, § 11 (providing the Court with discretion to make wide-ranging orders in respect of a debtor company as part of the grant of stays of proceedings). Over time the courts have developed a practice of permitting debtors to obtain DIP financing as part of first day orders).

80. 2006 Proposed Amendment, *supra* note 62, § 65 (which would replace Section 11.2 of the CCAA, *supra* note 64).

81. 2006 Proposed Amendment, *supra* note 62, § 18 (which would add a new Section 50.6 to the BIA, *supra* note 63).

82. Section 18 of the 2006 Proposed Amendment, *supra* note 62, §§ 18 (which would add a new Section 50.6(1) to the BIA, *supra* note 63), and 65 (which would replace Section 11.2(1) of the CCAA, *supra* note 64).

83. 2006 Proposed Amendment, *supra* note 62, §§ 18 (which would add a new Section 50.6(3) to the BIA, *supra* note 63), and 65 (which would replace Section 11.2(2) of the CCAA, *supra* note 64).

84. 2006 Proposed Amendment, *supra* note 62, §§ 24 (which would add a new Section 64.2(1)(b) to the BIA, *supra* note 63), and 66 (which would add a new Section 11.52(1)(b) to the CCAA, *supra* note 64).

85. 2006 Proposed Amendment, *supra* note 62, §§ 24 (which would add a new section 64.2(1)(a) to the BIA, *supra* note 63) and 66 (which would add a new Section 11.52(1)(a) to the CCAA, *supra* note 64).

86. 2006 Proposed Amendment, *supra* note 62, §§ 24 (which would add a new Section 64.1(1) to the BIA, *supra* note 63), and 66 (which would add a new Section 11.51(1) to the CCAA, *supra* note 64).

of any "interested party" to the extent that according such a security would be necessary for their effective participation in the proceedings.[87] As is the case with the other new priority charges contemplated by the Proposed Amendments, courts would be empowered to determine the relative rank of these various charges—both among each other and vis-à-vis existing, pre-stay security interests—and thereby establish an *ad hoc* yet binding priority scheme in respect of the debtor's assets.[88]

d. Corporate Governance

Among the many innovations to existing insolvency practice that would be provided by the Proposed Amendments is a change to some fundamental corporate governance principles as they apply to the restructuring context. The BIA and CCAA would be amended to expressly give judges power and discretion to remove and replace a debtor's existing directors based on a prospective consideration of whether they are "likely to unreasonably impair" the debtor's reorganization.[89]

e. Sale of Assets and Vesting Orders

Another notable innovation contemplated by the Proposed Amendments is a requirement that courts approve any sale of the assets of a debtor made out of the ordinary course of its business, based on a number of criteria.[90] Past practice, developed by the courts in the absence of explicit statutory direction, has been inconsistent in this respect. The proposed criteria for approval of such sales are more onerous in the case of proposed transactions to non-arm's length parties.[91] The court is empowered to issue a vesting order directing that a debtor's or bankrupt's secured creditors have a security interest only in the proceeds of the sale, with the successful purchaser taking the assets free and clear of any creditor interests.[92]

f. Deferred Status for Shareholder-Related Claims

Current Canadian insolvency legislation does not distinguish between "ordinary creditor claims" and claims arising from share-related transactions. This is seen as a systemic flaw. The Proposed Amendments would provide for deferred status for such share-related claims.[93]

87. 2006 Proposed Amendment, *supra* note 62, §§ 24 (which would add a new section 64.2(1)(c) to the BIA, *supra* note 63), and 66 (which would add a new Section 11.52(1)(c) to the CCAA, *supra* note 64).

88. 2006 Proposed Amendment, *supra* note 62, § 24 (which would add a new Section 64.2(2) to the BIA, *supra* note 63), and 66 (which would add a new Section 11.52(2) to the CCAA, *supra* note 64).

89. 2005 Proposed Amendment, *supra* note 65, §§ 42 (which would add a new Section 64 to the BIA, *supra* note 63), and 128 (which would replace Section 11.4 of the CCAA, *supra* note 64).

90. 2006 Proposed Amendment, *supra* note 62, §§ 27 (which would add a new Section 65.13 to the BIA, *supra* note 63), and 78 (which would add a new Section 36 to the CCAA, *supra* note 64).

91. 2006 Proposed Amendment, *supra* note 62, §§ 27 (which would add new Sections 65.13(4) to 65.13(6) to the BIA, *supra* note 63), and 78 (which would add new Sections 36(4) to 36(6) to the CCAA, *supra* note 64).

92. 2006 Proposed Amendment, *supra* note 62, §§ 27 (which would add a new Section 65.13(7) to the BIA, *supra* note 63), and 78 (which would add a new Section 36(7) to the CCAA, *supra* note 64).

93. 2006 Amendment, *supra* note 62, § 49 (which would add a new Section 140.1 to the BIA, *supra* note 63).

g. Cross-Border Proceedings

The Proposed Amendments contain provisions that largely, but not completely, adopt and incorporate the substance of the United Nations Commission on International Trade Law (UNCITRAL) model law for recognition of foreign insolvency proceedings[94] into the BIA[95] and CCAA.[96]

h. Termination of Executory Contracts

The intent to harmonize the BIA and CCAA is most evident with respect to the treatment of executory contracts contemplated by the Proposed Amendments. Unlike in the United States, under Canadian restructuring practice there is no necessity for a debtor to adopt executory contracts; they remain in force unless otherwise affected by an authorized disclaimer. The Proposed Amendments would render largely consistent the types of executory contracts that can be disclaimed while a debtor is under BIA or CCAA protection.[97] These specifically exclude derivatives and other "eligible financial contracts"[98] and, to a certain extent, a licensee's ability to continue using the debtor's intellectual property.[99] In the past, under the BIA, leases of commercial real estate were the only executory contracts subject to disclaimer,[100] while under the CCAA the courts exercised wide discretion.[101]

The Proposed Amendments would expressly prohibit forced changes or disclaimers of collective bargaining agreements,[102] and so Canadian law will materially differ from U.S. law on this point.

Of note, even under the Proposed Amendments there would remain a notable divergence between the BIA and the CCAA in the treatment of critical suppliers. The 2005 Proposed Amendment (which was not sought to be amended by the 2006 Proposed Amendment in this respect) would provide for the recognition by a court—in CCAA proceedings only—of a person as a "critical supplier" who can be required to supply goods or services to a debtor on terms to be determined at the court's direction.[103] No similar

94. See UNCITRAL, 1997—UNCITRAL Model Law on Cross-Border Insolvency With Guide to Enactment, http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html (last visited Mar. 18, 2007) for a full text and status update regarding the model law.

95. Part XIII of the BIA, *supra* note 63, would be amended by Section 122 of the 2005 Amendment, *supra* note 65, which would add Sections 267 to 284 to the BIA, subject to the partial amendment of the 2005 Amendment and the CCAA by Sections 59 and 60 of the 2006 Amendment, *supra* note 62.

96. Section 131 of the 2005 Amendment, *supra* note 65, would add Sections 44 to 61 to the CCAA, *supra* note 64, subject to the partial amendment of the 2005 Amendment and the CCAA by Sections 80 and 81 of the 2006 Amendment, *supra* note 62.

97. *See and compare* 2006 Proposed Amendment, *supra* note 62, § 26 (which would add a new Section 65.11 to the BIA, *supra* note 63), with 2006 Proposed Amendment, *supra* note 62, § 76 (which would add a new Section 33 to the CCAA, *supra* note 64).

98. 2006 Proposed Amendment, *supra* note 62, §§ 26 (which would add a new Section 65.11(10)(a) to the BIA, *supra* note 63), and 76 (which would add a new Section 32(9)(a) to the CCAA, *supra* note 64).

99. 2006 Proposed Amendment, *supra* note 62, §§ 26 (which would add a new Section 65.11(7) to the BIA, *supra* note 63), and 76 (which would add a new Section 32(6) to the CCAA, *supra* note 64).

100. BIA, *supra* note 63, § 65.2.

101. *See* note 79 *supra*.

102. 2006 Proposed Amendment, *supra* note 62, §§ 26 (which would add a new Section 65.11(10)(c) to the BIA, *supra* note 63), and 76 (which would add a new Section 32(9)(c) to the CCAA, *supra* note 64).

103. *See* 2005 Proposed Amendment, *supra* note 65, § 128 concerning the proposed new terms of Section 11.4 of the CCAA, *supra* note 64.

provision is proposed in respect of BIA-based restructurings in either the 2005 Proposed Amendment or the 2006 Proposed Amendment.

5. *Concluding Remarks*

In general, should they come to pass in a form akin to the Proposed Amendments, legislative changes to Canada's restructuring laws should not significantly impair the traditional flexibility of Canada's restructuring processes. The codification of current practice that would be provided by the Proposed Amendments represents an attempt to strike a balance between a greater degree of predictability and uniformity and that traditional flexibility. However, despite the proposed further amendments found in the 2006 Proposed Amendment, there remain many detailed technical and drafting problems which, if not rectified, may lead to more litigation and potentially impair the Canadian credit markets.