

NOTES FOR A SPEECH BY AL HUDEC TO THE
ENERGY SECTION OF THE INTERNATIONAL BAR ASSOCIATION
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I would like to address three recent developments in Canadian law relating to restructuring of financially troubled resource companies. Each of these issues, together with a number of other matters, are dealt with in detail in my written paper, but I thought it would be useful to energy law practitioners in other countries.

RESTRUCTURING LEGISLATION

It is frequently asserted in international comparisons of domestic insolvency laws that Canada is traditionally a country essentially without effective insolvency workout legislation in that, under the existing Part III or proposal provisions of our federal bankruptcy legislation, a stay of proceedings cannot be obtained against secured creditors of the debtor.

This conclusion, however, is very much an over simplification in that, while it is true that the current proposal provisions of the federal Bankruptcy Act are seldom used or useful in complex restructurings in Canada, in the last ten years there

has been a very significant revival of interest in the provisions of the federal Company Creditor's Arrangement Act, a twenty section, federal statute originally passed during the Depression era of the 1930's and which has been successfully applied by insolvent debtors, particularly in the troubled real estate and energy industries, to provide a statutory framework for the court supervised restructuring of insolvent energy companies. The continued application of the CCAA by the courts in Canada has, in my view, resulted in the evolution in Canada of a very workable and flexible legal framework for the financial restructuring of financially troubled resource companies.

Let me briefly sketch for you the basis of the statutory regime for troubled loan workouts under the CCAA.

1. Under the CCAA, the debtor corporation, any creditor, the trustee-in-bankruptcy or a federally appointed liquidator can bring an application to reorganize the business affairs of an insolvent debtor under court supervision. The primary condition precedent to such an

application is that the debtor be insolvent pursuant to the statutory definition and that it have an outstanding issue of secured or unsecured bonds or debentures issued under a trust deed. The original intent of this latter provision was to restrict the availability of the CCAA to corporations that had complex financial structures and a large number of creditors, but, practically speaking, the requirement is now routinely satisfied by issuing bonds or debentures under the necessary trust deed immediately prior to a CCAA application solely for the purpose of technical compliance with the legislation. In deference to stated public policy purposes of the statute; that is the encouragement of commercial reorganizations, the Canadian courts have declined to set aside this procedure of creating instate trust deeds, at least where the issuance is made by the directors of the debtor company before their powers are assumed by a receiver-manager.

3. Nowadays, an application under the CCAA is usually commenced by a preliminary motion seeking a declaration that the CCAA applies to the

corporation and an order that the corporation file a plan of arrangement within a specified time period. The application will include a plan for the holding of meetings and a request for an order staying all actions, suits and other proceedings against the company.

4. The stay provisions under the CCAA are broad, such that anyone with a claim against the insolvent person, including not only secured creditors but, also, other contracting parties pursuant to a stay of proceedings.

In the recent case of Norcen Energy v. Oakwood Petroleums, for example, a Canadian court interpreted the stay provisions of the CCAA very broadly to restrain the action of co-participants in wells operated by Oakwood Petroleum who were seeking to replace Oakwood, as an insolvent operator, pursuant to the provisions of the standard CAPL Operating Procedure requiring the replacement of a an operator which has become insolvent. In the circumstances, the court

assessed that the failure to grant such a stay would prejudice the debtor corporation's ability to restructure its financial affairs.

5. The key to the successful application of the CCAA as a vehicle for successfully implementing major restructurings has been the flexibility applied by the courts in defining creditor classes. Under the CCAA, creditors of each class affected by the plan must approve the arrangement by a majority of those present at the meeting and representing three-quarters of the aggregate value of the class. The leading case applied by Canadian courts in defining creditor classes is the English case of Sovereign Life Assurance v. Dodd which established a community of interest test pursuant to which a court must divide creditors into different classes if it finds that a different state of facts existing among different creditors which may differently affect their minds and their judgment. As this rule has been interpreted by the Canadian courts, the mere fact that creditors hold separate security over different assets may be insufficient to constitute different classes where a court finds

that the recognition of such differences for purposes of classification would result in excessive fragmentation and make it impossible to implement any successful plan of arrangement. As a general rule, however, secured and unsecured creditors will be placed in separate classes, as will creditors with different priorities and shareholders of different classes, although there is a precedent for including preferred shareholders in the same class as common shareholders where there is essentially no equity and where placing preferred shareholders in a separate class would effectively provide them with a veto over the organization.

6. Following creditor approval of plan of arrangement must be sanctioned by a court at a fairness hearing in which the court will determine whether the statutory conditions precedent to the availability of an order have been strictly complied with and determines that the scheme is both so fair and reasonable that an intelligent and honest man who is a member of a class and in respect of his interest as a member might approve it.

As an aside, the CCAA can be used to reduce lender environmental risk during financial restructuring since it permits the creditor to leave the debtor in possession, while the creditors, for example, may provide a monitor to assess the scope and magnitude of any environmental problems.

THE PROPOSED NEW COMMERCIAL REGIME

New federal legislation has recently been tabled, in the form of Bill C-22, to enact comprehensive amendments to the current Bankruptcy Act, including proposals for a new regime governing court supervised reorganizations in commercial insolvencies.

The proposed new legislation is the culmination of protracted efforts since the mid-1970's to up-date Canadian bankruptcy laws to accommodate effective reorganizations and to rehabilitate insolvent but prospectively viable business enterprises.

The starting point for the new Canadian legislation is a perception in Canada that the balance under Chapter 11 of the U.S. Bankruptcy Code is tilted in favour of debtors to the detriment of secured creditors and equity stake holders.

As a result, there are some significant and deliberate differences between the new Canadian regime and the existing Chapter 7 regime. The primary features of the proposed new Canadian reorganization legislation which differentiate it from Chapter 11 are the following:

1. Pursuant to Bill C-22 only a debtor which is either insolvent or bankrupt will be entitled to initiate a proposal. Creditors will not be permitted to independently develop and put forward proposals. This is contrast to both the provisions of Chapter 11 and the existing CCAA, the latter of which permits creditors to institute a plan of arrangement.
2. A court proceeding will not be necessary to commence a proposal under the new bankruptcy legislation. Rather, a debtor intending to make

a proposal need only file a notice of intention to do so with the official receiver.

3. A debtor filing proposal or a notice of intent to file a proposal then has a thirty day period to do so or is deemed to have made an assignment in bankruptcy dating back to the date of the original filing of the notice of intention. Extensions can be granted on specified statutory grounds but cannot, in aggregate, exceed a total of a six month period. Specifically, the court must be satisfied that a viable proposal would be able to be made if the extension were granted. In practice, most of the major resource company restructurings proceedings under the CCAA have taken a considerably long period of time to complete. For example, the current restructuring of Quintet Coal Limited was commenced in June, 1990 and it has not yet reached the stage of final approval. My understanding under the U.S. rules is that the debtor has an initial 120 day stay period and that creditors may thereafter make their own proposals and that in any circumstances the courts have wide latitude to grant prolonged stays.

4. Under the commercial proposal provisions of Bill C-22 no class of creditors can be adversely affected without its approval, although, of course, individual creditors within a class can be compromised pursuant to a vote of the class by the required majority. In other words, there is no provision in the Canadian legislation for a cram-down of secured creditors in the U.S. sense of that term. As I understand the comparable U.S. provisions under Chapter 11, even if a consensual plan cannot be formulated and a class of creditors rejects plan, the debtor in possession may still confirm the plan over the creditor's exemption if it proposes to pay the dissenting class at least as much as it would receive under a liquidation and a court determines that the dissenting class is being given fair and equitable treatment. The new Canadian legislation does not, as does the U.S. legislation, include the power of a court to authorize a trustee under a proposal to raise needed funds and to provide superpriority security in respect of such loans. My understanding of the U.S. rules is that Chapter 11 proposes a procedure whereby a company can

seek new post filing financings without a hearing or court approval by incurring unsecured debt and obligations in the ordinary course of business and that if credit can only be obtained by the debtor outside of the normal course, a hearing and court approval will permit the debtor in possession to obtain unsecured credit on an administrative priority basis or credit secured by junior liens on a state property or, under exceptional circumstances, credit secured by a lien which is senior to existing liens on a state property provided that the so-called primed lien is adequately protected. Bill C-22 does, however, make explicit that a court may give an interim receiver a first charge on assets of the debtor for the receiver's fees and expenses and that such first charge takes precedence over all other creditors including secured creditors.

6. Under Chapter 11, a debtor in possession may assume or reject executory contracts, that rejection of a executory contract by the debtor in possession requires a court approval based on a court's determination that the rejection satisfies a business judgment standard and that

the rejection of the contract by the debtor in possession is treated as a pre-petition breach excusing the debtor in possession from further performance and giving the non-debtor an unsecured claim that is deemed to have arisen at the moment the bankruptcy petition was filed rather than at the time of the actual rejection. The non-debtor also has a separate administrative expense claim for the debtor's post-petition use of the property prior to rejection. In Canada, although the 1986 Coulter Commission recommended that provisions be added to permit the repudiation or variation of executory contracts, the legislation, as drafted, provides only for the repudiation of long-term real estate leases under specified circumstances.

7. Under Bill C-22 a stay of proceedings will be lifted only where it can be demonstrated that a creditor would be significantly prejudiced by the continuation of a stay. It remains to be seen whether the grounds that have been articulated by U.S. courts for lifting a stay under Chapter 11 for cause will parallel the court's interpretation of significantly prejudiced in the

Canadian context, although I would expect that stays will be lifted in circumstances similar to the lifting of stays for cause under the U.S. legislation, such as where the creditor's security is deteriorating significantly in value or is being used for the benefit of other creditors.

8. There is no express provision in Bill C-22 to empower a court to make consolidation orders allowing a notice of intention to be filed in relation to a group of companies where they are operating as a single business and it is not practical to disaggregate the assets and liabilities of the individual companies.

9. Although in its current form Bill C-22 does not contain a provision similar to the recent amendments to Chapter 11 of the U. S. Bankruptcy Code which protects parties to financial hedging contracts such as interest in currency swap agreements where a counterparty becomes insolvent by permitting such contracts to be terminated in the case of counterparty insolvency. However, I

understand that changes likely to be made to the next draft of Bill C-22 when retabled to provide similar relief in Canada.

10. Chapter 11 is based on a concept of debtor in possession whereby the debtor in possession has most of the authorities, powers and duties according to a trustee under the bankruptcy code, including the right to take control over all property of the debtor to operate its business and to exercise all of the avoiding powers of a trustee. Bill C-22 gives a Canadian court a wide power at any time after a debtor has filed a notice of intent to file a proposal to appoint a trustee as interim receiver of all or any part of the debtor's business and to direct the receiver to take possession of the debtor's property, exercise control over the properties the court considers advisable. There is no concept in the new Canadian legislation similar to the idea of a creditors committee under Chapter 11. My understanding is that Chapter 11 requires a court to approve a creditors committee as soon as practical after a filing of petition.

11. The current version of Bill C-22 contains a very rigid definition of classes which requires that secured claims be regarded as being in the same class if they are secured against the same assets and rank at the same level. This formulation of the definition has been generally criticized by various commentators and it is likely that the next draft of the Bill will provide a more fulsome and flexible guidance to the definition of classes. In particular, it is likely that it will be based on the common law test for defining classes as applied in the CCAA cases and will provide that secured claims may be included in the same class if the interest of the creditors holding the claim are sufficiently similar to give them a commonality of interest taking into account factors such as the nature of the claims, the nature and priority of the security of the claims, the remedies available to the creditors and the likelihood that the claims would be recovered absent the proposal and the treatment of claims and the likelihood that the claims would be recovered under the proposal. The revisions will probably also provide that anyone who is affected may apply to a court for

directions on class structure and that the court, on application, may determine the classes of claims secured creditors appropriate to the proposal and the class into which each claim falls.

ENERGY LENDERS ENVIRONMENTAL RISKS

In Canada, as elsewhere, recent statutory and judicial developments in the area of environmental law have imposed increasing environmental liability risks on energy lenders. Under recent Canadian changes to accounting standards, Canadian energy companies are required to book their future reclamation obligations against current income and in Canada, as elsewhere, Canadian energy lenders have become astute at factoring in the impact of reclamation costs in assessing a debtor's ability to repay a loan and in appraising the value of their security.

As elsewhere, however, the major concern to Canadian energy lenders are the potential liabilities, in excess of the value of the loan and

of their security, which can result from the imposition of potentially unlimited environmental clean-up obligations on lenders or their trustees in a receivership situation where the bank or its receiver take ownership and control of an environmentally tainted property and thereby assume environmental compliance and clean-up obligations.

The recently prominent Canadian case in the energy context is a decision of the Alberta Court of Appeal in Panamericana v. Northern Badger, a case in which a receiver for a bank sold the debtor's valuable properties to a third party purchaser in an arms-length sale and left the trustee-in-bankruptcy holding the undesirable exhaustible wells with their associated abandonment and reclamation obligations.

The Alberta Court of Appeal, overruled a lower court decision which had imposed liability on the bank's receiver, and hence on the energy lender through its indemnity of the receiver, on the grounds that to do otherwise would subvert the statutory regime of priorities in the federal bankruptcy legislation which recognizes the priority of a secured creditor over unsecured claimants.

Instead, the Court of Appeal held, a trustee is responsible for cleaning up under generally applicable legislation enacted for the public good.

The result in the Northern Badger case is distinctly different from the recent decision of the U.S. Court of Appeals for the Second Circuit in the U.S. v. LTV case, which in my mind, provides a logical basis for sorting out the relationship between environmental protection legislation and bankruptcy law.

The LTV case distinguished between environmental legislation which imposes obligations essentially in the form of pure injunctive relief; that is, under which a person controlling a polluted site may be enjoined from ongoing pollution and ordered to remove the toxic waste, but pursuant to which the regulatory authority has not authority to accept payment as an alternative to continued pollution and legislation where the environmental agency may either order clean-up or clean-up itself and recover the costs.

The legislation in Alberta, administered by our Energy Resources Conservation Board, is of the latter variety and, hence, under LTV principles, a U.S. court presumably would have treated the statutory clean-up obligation in Alberta as a claim compromisable or dischargeable in bankruptcy.

The other major difference between Canadian and U.S. environmental law as applicable to lenders, at least in its current stage of evolution, is a current tendency in Canada in drafting new environmental legislation to impose liability for clean-up on anyone who owns or controls a polluted property and on their receivers and trustees. Generally, Canadian legislatures have not, as yet, articulated clear secured lender exemptions under Canadian environmental laws as such are available under CIRCLA, the U.S. superfund legislation, particularly as clarified by the proposed EPA Guidelines which define the permissible scope of lender's activities which may be undertaken to protect a secured interest without incurring environmental liabilities.

I do not mean to imply, however, that Canadian energy lenders face a more acute level of environmental risks than do their American counterparts in that, generally, Canada is still significantly behind the United States in terms of vigorous enforcement of its environmental statutes. For example, in Alberta, we are only currently in the process of shifting from environmental legislation based on a negotiated compliance policy to one based on a philosophy of prosecutorial adherence to strict standards with stiff fines and penalties.

OTHER DEVELOPMENTS

My third and final point is to draw your attention to some other significant legal developments that have occurred in the Canadian energy industry as a result of our experiences in dealing with financially distressed resources companies.

As a result of these experiences and some of the ensuing case law, the major Canadian commercial banks engaged in energy finance have revised their lending and realization practices and their

standard energy financing documentation and industry associations and participants have made several important changes to standard industry agreements and practices.

Let me give you several illustrative examples:

- (a) as a result of their experience in the course of realizations in the early 1980's, I believe that Canadian chartered banks now generally recognize the limitations of Section 177 security, a short form of security available only to chartered banks under the Bank Act. The scope of the charge granted pursuant to Section 177 is statutorily defined and does not constitute a comprehensive charge on all of the assets of a debtor necessary to realize against an oil and gas company as a going concern. Specifically, the charge granted pursuant to Section 177 security is limited to the charging of the interests of the borrower in petroleum and natural gas leases, hydrocarbons in the ground, inventory in storage and the on-lease

pipelines, casing and equipment used in extracting, producing and storing such hydrocarbons.

The scope of Section 177 security does not, for example, include off-lease downstream assets such as pipelines, gathering systems, tank batteries, compressor stations or processing plants and does not encompass the various contractual rights and interests required to operate the secured properties and to process and market production. Nor does Section 177 security give the bank security over royalty or net profits interests.

Therefore, although, perhaps, I am over generalizing a bit, I believe that the prevailing view in Canada is now that fixed and floating charge debenture security is preferable to Section 177 securities as a means of securing oil and gas production loan facilities except, perhaps,

in those provincial jurisdictions where registration of security interests other than Section 177 security is not available.

2. As a result of difficulties experienced by industry participants in their dealings with insolvent operators and other participants in industry joint ventures during the 1980's industry practices and standard industry operating agreements have evolved to deal with these concerns.

For example, under the 1981 form of the CAPL standard form Operating Procedure, non-defaulting participants in wells frequently experienced difficulties in removing financially distressed parties or operators because of the difficulty of proving insolvency in sufficient time to protect their interests. In some cases, non-operators were left in the position of having their joint venture properties managed by a receiver- manager of the operator who had little or no operational experience.

As a consequence, the 1990 version of the CAPL Operating Agreement was revised to provide that receivership results in the automatic removal of an operator. Notwithstanding these new provisions, as I indicated previously, Alberta courts may grant an insolvent operator a temporary stay under the CCAA preventing the termination of its operatorships in workout situations so as to permit the operator to continue as a going concern while it negotiates an arrangement with its creditors.

3. The other basic problem that the Canadian industry has had to grapple with is the commingling of the marketing proceeds and amounts advanced for capital funding belonging to non-operators with the operators general funds in cases where the operator subsequently experiences financial difficulties.

Most oil and gas operating agreements in Canada, including 1981 form of the standard CAPL agreement, authorize the operator to sell production on behalf of its co-participants and

to mingle both production revenues and funds advanced pursuant to cash-calls under AFE's with the funds of the operator in the operator's general operating accounts.

In the leading case of Bank of Nova Scotia v. Societe Generale, the Alberta Court of Appeal analyzed the 1981 Operating Procedure as a whole and determined that, notwithstanding the expressed authorization to commingle provided in the Agreement, the intent of the parties was that the operator act for the benefit of all of the co-venturers and that the party's intended to create a trust relationship.

The court noted that although the clause standard in such agreements permitting comingling would, under traditional trust law principals, be generally considered as weighing heavily against the finding of a trust was nevertheless non-fatal to the existence of a trust in this circumstance because of the intent of the parties judged from the agreement as a whole.

In light of the Sorrel decision, the new 1990 CAPL Operating Procedure expressly provides that notwithstanding the comingling permitted under the agreement, monies of a participant advanced or paid to the operator, whether as proceeds from the sale of production or for the conduct of operations, are deemed to be trust monies.

This provision does not, however, resolve all of the problems of non-defaulting participants since they may still be unable to trace funds passed through the general current account of the operator. The true remedy of the other participants in response to an insolvency of an operator is to begin to table their share of production in kind as they are entitled to do under the agreements.

As to the comingling of funds used to pay capital expenses, it is quite common, in my experience, in major ventures to require the operator to establish a separate designated trust account in the names of the co-venturers into which funds advanced for capital expenditures are contributed.

CONCLUSION

In conclusion, my impression from reading the very fine papers of both Tony Brown and Mike Sutherland is that there is a great deal of parallel between both the experiences and the legal responses to oil and gas company restructurings in Canada and the United and Australia and I refer you to the detailed papers for the details.