FEATURE

Ripple Effect

A stressed economy means more restructuring and insolvency and more cost pressures for lawyers

BY SANDRA RUBIN

AS ONE SENIOR RESTRUCTURING LAWYER LIKES TO SAY, when the economy gets tough it's time to put away the golf clubs. Well, the clubs have been stashed for some time. But there haven't been as many of the old-style restructurings or insolvencies as you might expect given the protracted commodities slump.

Junior resource companies in particular are being hard hit. Everyone's keeping it lean. But rather than restructuring, some have sold themselves to hedge funds or to debtors, which essentially involves just a transfer of assets and a new management team. Those with even a small amount of production can forward sell part of their royalty stream to keep the wolf from the door.

Mary Buttery, Co-chair of the national Insolvency and Bankruptcy Group at Davis LLP in Vancouver, says her group is busy but "different busy" from the last major downturn of 2008-2009. "Our role is less as an advocate and more as an advisor helping companies restructure their debt and restructure contracts outside of a formal process," she says. "More negotiation, more co-operation, less advocacy is the best way to put it."

Jay Swartz, a partner at Davies Ward Phillips & Vineberg LLP in Toronto, says he's seeing sales under the *Companies' Creditors Arrangement Act* but "I'd have to stretch my mind to think of the last time a company did a true restructuring."

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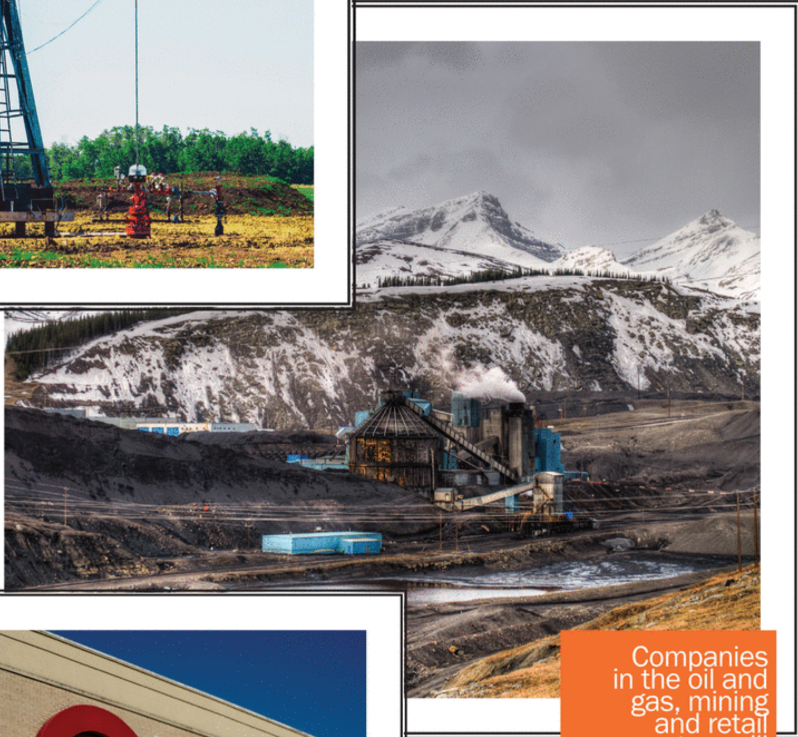

Companies in the oil and gas, mining and retail sectors will all require restructuring in Canada.

That may be about to change.

With money so cheap over the last couple of years, more than a few Canadian companies have been built up on a foundation of low interest debt.

Low interest rates can paper over a myriad of problems but send a few tremors through the economy – sustained low oil prices or rising rates – and the cracks start to show. Miners are witness to the problems that can result from carrying high-yield debt when the underlying commodities prices tank.

The International Energy Agency says the global break-even price of oil is over US$80 per barrel. With prices far below that there is concern the oil and gas sector – the driver of the Canadian economy – could be next. In 2009, the last time oil prices cratered, roughly $90-billion worth of Canadian energy expansion plans were put on hold.

While large Canadian players have the financial wherewithal to survive a long bumpy patch, many junior explorers and producers don't. There are predictions of "blood on the streets" for companies that are not able to keep their debt-to-cash ratios below manageable levels.

HEATHER FERRIS
> LAWSON LUNDELL LLP

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Even the large well-capitalized companies have begun pulling in their horns. Suncor Energy Inc. chopped $1 billion from capital expenditure and laid off 1,000 people, Canadian Natural Resources Ltd. slashed spending by about 28 per cent, Shell Canada Ltd. cut 300 jobs — the list was expected to grow through the first part of this year.

Those cuts are rippling through the oil-services companies that supply rigs and other essential services. Stress cracks have also begun to appear in the wider economy.

All this should be good news in a way for the corporate law firms that depend on insolvency and restructuring as a key contra-cyclical source of revenue. *Should* be. But that may be about to change, too.

Clients have begun demanding the same kinds of fee reductions in restructuring as they do in other kinds of corporate work, says Gavin MacDonald, a partner who does a lot of lenders' work at Cox & Palmer in Halifax.

"The lenders are increasingly pushing down on costs looking for alternative fee arrangements," he says. "They're holding the line on hourly rates and having a much more detailed discussion about the necessary level of seniority on different matters — all with a view to controlling costs.

"In the past, sometimes when a debt was being written off anyways, there may not have been the same concern. There is much more concern now."

In law firms, too.

THE 2008-2009 FINANCIAL crisis was such a shock to the system that credit completely froze. This time is different. The money is there but it's being deployed extremely selectively, says Tony Reyes, Co-chair of the insolvency and restructuring team at Norton Rose Fulbright Canada LLP in Toronto.

"In Canada there doesn't seem to be a lot of risk capital," says Reyes. "There's a lot of capital – pension funds and so on have money to invest – but lenders are not investing it in anything that has a fair amount of risk attached to it."

Lenders are being surprisingly patient. While not interested in advancing new capital they have generally not been forcing a wholesale restructuring of the debt. A good run in stock markets has given them some extra breathing room, Reyes says.

"Extend and pretend – extending loans and hoping for the best – has been a very sensible strategy in the last few years," says Reyes. "But if we see a downturn, if the market starts to go a bit south and the economy slows, then the banks are going to start thinking: 'How do we deal with this asset? We've let it limp along long enough.'"

Some lenders are likely still sitting tight because of the potential ramifications of calling in a loan, says Richard Orzy, leader of the national restructuring and insolvency practice Bennett Jones LLP in Toronto.

"There's a theory the reason you don't see more bankruptcies in Europe is because if the banks called one loan of a certain type, they'd have to call 300 loans of a certain type, so it would really impact their own valuations," he says. "Right now, they show those loans on their books and they're not so bad.

"The same sort of theory applies here, although hopefully not to the same extent. There may be some lenders out there who'd

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much rather foreclose and sell the thing off, or find a buyer and just take whatever they can, but they might have seven or 27 of these in their portfolio. If they realize an amount for one that is lower than the value they were carrying it at, the implication might be all of the values have to be written lower."

A chill on Canada's resource sector, the driver of the country's economy, is expected to have a significant knock-on effect in other areas. From retail to real estate, anxiety is mounting.

Target Corp. shuttered its 133 Canadian stores, Sony Canada closed all 14 of its Canadian stores, Mexx Canada put itself into liquidation, 107 Smart Set stores are closing, Jacob abandoned restructuring efforts and decided to close, and Bombay & Co., Bowring & Co. and Benix & Co. stores decided to put themselves under court protection.

Orzy says clothing retailers, in particular, face significant hurdles. "Whatever's in the store in May has to have been ordered back in September, so there's a long supplier lag. The more insolvencies, the more suppliers will be demanding payment up front, which means the less you can order. Plus with the Canadian dollar down, the round you order for next spring will be more expensive than it was last year.

"You can get into a downward spiral because of those kind of issues. So I think a lot of people are looking to retail as *the* restructuring area in 2015."

If he's right, the effects will further batter Canada's manufacturing sector and roil the large commercial real estate companies left holding worthless leases.

The economy appears to be heading towards a tipping point, says Reyes of Norton Rose. "I think we're coming to the end of the cycle where people have been waiting to see. I think they'll now move on to strategic realizations or restructurings."

For restructuring and insolvency lawyers, signals are there will be more and more work in the months to come.

And more discussions over cost.

THERE WAS A time not very long ago when an insolvency or major restructuring was akin to a blank cheque. That time may have come and gone.

It's not just clients pushing to get work done at better prices. In court-supervised insolvencies, with no in-house counsel or corporate manager to keep an eye on expenses, the Bench has begun to question fees, says Heather Ferris, a senior insolvency and banking partner at Lawson Lundell LLP in Vancouver.

"What's being talked about more than anything these days is: Is the insolvency Bar pricing it outside of the market?" Ferris points out. "There have been some very recent cases out of British Columbia, Alberta and Ontario that seem to have directed a shot across the bow at the practice, saying enough is enough."

One case she and other practitioners point to is *The Bank of Nova Scotia v. Daniel A. Diemer o/a Cornacre Cattle Co.* It started when the Ontario Superior Court of Justice refused to approve legal fees of $256,000 for a two-month workout of a London, Ont., cattle farm, with the motions judge calling the legal fees "nothing short of excessive."

The farm had been put into receivership in 2013 about $5 million in debt. The receiver retained the Toronto partner of a national firm as counsel (about a two-hour drive away) instead of using a local lawyer in London, where fees tend to be lower, the court noted.

The national firm had docketed 397 hours between Aug. 6 and Oct. 14, at an average hourly rate of $643.75. That ranged from $950 an hour for a senior partner to $195 an hour for a law student.

The judge held that the work carried out, especially by senior counsel, was disproportionate to the size of the receivership, which he characterized as modest in scope. He approved a payment of $100,000 with the rest to be determined later.

The decision was appealed.

The Ontario Court of Appeal noted there is little jurisprudence in the area, saying right off the top that in most lawyer-client interactions, the client has the chance to try and keep fees down. In insolvencies they do not.

"In a court-supervised insolvency, stakeholders with little or no influence on the fees may ultimately bear the burden of the largesse of legal expenditures," wrote Justice Sarah Pepall.

"In my view, it is not for the court to tell lawyers and law firms how to bill. That said, in proceedings supervised by the court and particularly where the court is asked to give its *imprimatur* to the legal fees requested for counsel by its court officer, the court must ensure that the compensation sought is indeed fair and reasonable."

She held that not all of it was, saying the lower court judge was correct to question "why a senior Toronto partner had to attend court in London to address unopposed motions."

The appeal was dismissed. The decision was unanimous.

"I think those kinds of comments from the Bench are going to affect the way we carry on our practice," says Ferris. "I think that's where we're going."

IN THE MEANTIME, many distressed companies aren't looking only for lower

rates, they're looking for cheaper ways of doing a corporate workout.

There's no question the *Companies' Creditors Arrangement Act,* or CCAA, is the gold standard for large corporate restructuring. There's also no question that it is expensive, requiring a court-appointed monitor and monitor's counsel. Proceedings can also go on for years.

Clients looking for cheaper ways to reorganize are increasingly looking at the possibility of using either the *Canada Business Corporations Act* (CBCA) or the *Bankruptcy and Insolvency Act* (BIA).

MacDonald of Cox and Palmer says he and his partners throughout Atlantic Canada are seeing a lot of workouts done through the BIA. "I'd call it a real trend."

A BIA restructuring is cheaper because the Act lays out a detailed code of procedure and stipulates that the restructuring proposal must be agreed upon within six months or the restructuring fails.

A series of 2009 amendments also made it more attractive for complicated issues. It now allows for debtor-in-possession financing with a priority charge, for example, and provides for the pre-proposal sale of assets.

"With these new provisions, now that lawyers are becoming more familiar with them, we're seeing more complex proposals but still within a smaller scale than the CCAA," MacDonald says.

Workouts done under the BIA require the oversight of a trustee, but restructurings under the CBCA do not involve the day-to-day supervision of a court-appointed officer at all, meaning fewer court hearings and fewer fees.

It also means less independent oversight.

The use of the CBCA has become a bit of a "hot-button issue" in the Bar, says Sean Collins, who leads the Bankruptcy & Restructuring and Litigation practices at McCarthy Tétrault LLP in Calgary.

"There's certainly a lot of discussion in the industry of issuers who are willing to use the CBCA as opposed to the CCAA," he says. "There's a perception you can do a CBCA restructuring quicker and for less professional-fee burn.

"There are also those corporate directors who would prefer a *Canada Business Corporations Act* restructuring because of the disclosure obligations you have to make if you're a director of an entity that restructures under the CCAA. The talk out there is there is serious consideration of using the CBCA."

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Another element that can make a CBCA workout more attractive than the alternatives is that the company does not have to declare itself insolvent, avoiding the reputational harm and problems with creditors that can cause.

Despite the benefits, Collins does not believe the CBCA is the best route to go in all cases. "I've used the CBCA for insolvencies myself, it's a matter of degrees between being cash-flow and liquidity insolvent and being hopelessly balance-sheet insolvent. In the latter case, I'm not certain the CBCA is the panacea it's being made out to be.

"It's easy to say the CCAA is empirically more expensive but that's not always the case. With the CBCA you don't have to pay the monitor's fees, or the monitor's counsel's fees, but if you embark on that process and it's ultimately not successful or a transaction is affected that doesn't fully address the underlying problems then you're no further ahead. And you've just spun your wheels."

Reyes of Norton Rose says it's a trade-off. "You don't affect the little guys, the small trade creditors and that kind of thing, in a CBCA. You'll often see a swap of debt, bonds and debentures, for the security and that's all that happens. Unfortunately, a lot of the little guys are shareholders too and they see things happen quite quickly through discussions between bondholders and the company that dilute or even eliminate the equity.

"That's where people are a little bit alarmed because that happens without a monitor present, without an independent source of information for the court."

The number of CCAA filings far outstrip the use of the CBCA, senior practitioners agree. There is a lot of maneuvering that can be done under the CCAA that can't be duplicated under the *Canada Business Corporations Act*. Dealing with the consequences of big litigation, for instance.

That avenue is not entirely without controversy either.

THE COMPANIES' CREDITORS ARRANGEMENT ACT, enacted in the Great Depression, was designed to serve the interests of the public as well as investors, creditors and employees of the affected company, so it gives judges extremely broad latitude and significant discretion.

The Castor litigation is a perfect example of how it is being used in creative ways. Montréal-based Castor Holdings, a real estate-financing company, went bankrupt in 1992.

Ninety-six plaintiffs, including Chrysler Canada, which lost hundreds of millions of dollars from its pension fund in the collapse, sued the former Coopers & Lybrand for damages of more than $1 billion in connection with financial audits carried out from 1989 to 1991. The plaintiffs named 311 individual partners of the auditor as defendants in the suit.

Coopers & Lybrand merged with Price

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