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The CCAA and Real Estate Development Companies

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The CCAA[2] is the most flexible Canadian statute under which a corporation can restructure its business. When compared against the BIA,[3] the CCAA looks like a blank canvass and lends itself well to invention and mutual compromise. The overarching goal of the CCAA is for the debtor corporation to formulate a plan of compromise or arrangement that is approved by the corporation's creditors or to effect a going concern sale, both of which are intended to provide greater value to the creditors than if the debtor corporation were liquidated under the BIA.

However, proceedings under the CCAA are expensive and typically involve priority charges over the property of the debtor corporation for professionals, directors and officers of the debtor corporation, and interim financing, which can have the effect of eroding creditors' realization.

Despite the flexibility of the CCAA, certain types of businesses may be less suitable for its application. Three recent decisions of the Ontario Superior Court of Justice (Commercial List), *Dondeb*,[4] *Edgeworth*[5] *and Hush Homes*,[6] involved real estate development companies seeking protection under the CCAA. These cases all shared similar facts: the debtor corporations were in the business of real estate development and investment and had several single-purpose subsidiary corporations, each of which owned a discrete piece of real estate. Each piece of real estate was encumbered by at least one mortgage and many were cross-collateralized. Mortgages accounted for the vast majority of the first-ranking secured indebtedness. The debtor corporations sought protection under the CCAA and certain of their respective lenders opposed the applications on the basis that it would be more advantageous and cost efficient for them to proceed with an orderly sales process under their respective mortgage security.

Dondeb

In *Dondeb*, the debtor corporations sought relief under the CCAA to enable a liquidation of their assets and property. DIP financing and a charge to secure it, as well an administrative charge to secure the fees and expenses of the professionals involved in the CCAA administration, were all sought. The application was opposed by various secured lenders who collectively held approximately 75% of the value of the secured indebtedness. The basis for the opposition was that: (i) the properties would be more appropriately sold under the mortgage security; (ii) the DIP financing and administration charges unnecessarily burdened the equity of the properties; (iii) the

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[1] Ian Aversa is a partner in the Financial Services Group and Jeremy Nemers is an associate in the Financial Services Group. The authors would like to thank Daniel Everall, a student-at-law at Aird & Berlis LLP, for his assistance in preparing this paper.
[2] *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 [CCAA].
[3] *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 [BIA].
[4] *Re Dondeb Inc.*, 2012 ONSC 6087 [*Dondeb*].
[5] *Romspen Investment Corp. v. Edgeworth Properties, et. al.,* 10 November 2011, CV-11-9452-00CL, Receivership Order of the Honourable Justice Campbell (Ont. S.C.J. [Comm. List.]) and *Re Edgeworth Properties Inc., et. al.,* 10 November 2011, CV-11-9409-00CL, CCAA Order of the Honourable Justice Campbell (Ont. S.C.J. [Comm. List.]) [*Edgeworth*].
[6] *Re Hush Homes Inc.*, 2015 ONSC 370 [*Hush Homes*].

lenders had lost all faith in management and its ability to generate revenue from the real estate; and (iv) no plan would be realistically accepted by the lenders because there was no underlying business to restructure that would yield greater value for them than through enforcement of their own respective mortgage security.

In the result, the Court refused to grant the requested relief under the CCAA for the reason that a successful plan could not be presented that would receive creditor approval in any meaningful fashion. Instead, Justice Campbell issued a receivership order under the BIA which, in His Honour's view, would achieve an orderly liquidation of most of the properties and protect the revenue from the operating properties with the hope of some recovery of equity in those properties not "under water". Each property subject to the receivership was compartmentalized such that all of its revenues and expenses were allocated to that particular property. His Honour noted that using the CCAA for the express purpose of a liquidation must only be done with caution, particularly when the alternative of an overall less expensive receivership can accomplish the same goal.

Edgeworth

The facts in *Edgeworth* are functionally equivalent to *Dondeb*, except that in *Edgeworth*, only one of the underlying properties was fully developed and there were several thousand secured and unsecured creditors independent of the first-ranking mortgagees. The applicant corporations sought relief under the CCAA as a means to provide a single comprehensive forum to address all stakeholder claims. The mortgagees opposed the application on grounds similar to those in *Dondeb*, including a loss in faith of management, there being no viable business to restructure, and the erosion of equity due to the priority DIP financing and administration charges.

In the result, the Court issued two concurrent orders: one under the CCAA to provide a single and comprehensive forum for all stakeholders, and another receivership order under the BIA, which allowed for the appointment of a receiver over the various properties subject to mortgages. However, the outcome of the *Edgeworth* proceedings, which pre-dated the decision in *Dondeb*, may not have been as effective or efficient as initially envisioned and likely weighed in the Court's treatment of *Dondeb*.

Hush Homes

Most recently, in *Hush Homes*, the Court again considered an application for an initial order under the CCAA to restructure a developer with several single-purpose subsidiary corporations. The secured creditor with a first-ranking mortgage over one of the development sites, at the time still raw land not even zoned for the proposed housing use, opposed the order as it preferred to commence power of sale proceedings per its rights as mortgagee. Unlike *Dondeb* and *Edgeworth*, however, the debtors' proposed plan contained a repayment of the secured creditor's first-ranking mortgage.

The Honourable Justice Penny reviewed the case law surrounding development companies and the CCAA, noting that the priorities of security are often straightforward and, in the cases dealing with raw land, there may be no business activity being carried out. However, His Honour emphasized the discretionary nature of both an order appointing a receiver and an initial order

under the CCAA, and further noted that there is no "generic" prohibition against a land development business obtaining protection under the CCAA.

Justice Penny did not see how the objecting creditor would be worse off under the CCAA than in a receivership process. His Honour found "on the unique facts of this case" that the prejudice to the objecting creditor would be roughly the same whether realization took place in a receivership or a CCAA context and, therefore, granted the relief sought under the CCAA.

Conclusion

Debtor companies with disparate real estate development and investment properties in different entities and encumbered by first-ranking mortgages from several lenders may have difficulty proposing a plan that is more advantageous than the remedies available to the mortgagees under their respective security. There is little incentive for these lenders with first-ranking security to agree to a plan that will likely involve the erosion of their security in favour of priority DIP financing and administration charges. If a debtor corporation is insolvent and not able to complete the development of its real estate properties without further funding, its mortgage lenders may be in a better position by asserting their respective mortgage remedies rather than permitting management to remain in control under the CCAA. Any proposed filing under the CCAA will need to take into account the potential prejudice to first-ranking mortgagees.

The Importance of Full and Frank Disclosure in *Ex Parte* Hearings

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CanaSea[2] provides us with a reminder of the importance of full and frank disclosure in the context of *ex parte* applications under the CCAA.[3] In this case, the Honourable Justice Penny of the Ontario Superior Court of Justice (Commercial List) took the unusual step of declaring the initial CCAA order to be *void ab initio* because the applicants failed to provide adequate disclosure at the *ex parte* hearing. His Honour found that the subsequently produced evidence did not support the assertions made by the applicants regarding their eligibility for CCAA protection, and was critical of their failure to meet their "high obligations of candour and disclosure on an *ex parte* application." Leave to appeal was denied by a single judge of the Court of Appeal for Ontario.[4]

This case involved a network of related companies in the oil and gas field that can be collectively referred to as the "**CanaSea Group**". CanaSea PetroGas Group Holdings Limited ("**Holdings**"), a Canadian holding company, owned 100% of the shares of two Singaporean subsidiaries. The Singaporean subsidiary at issue, CanaSea Oil and Gas Group Pte. Ltd. ("**COGG**"), owned 100% of the shares of CanaSea PetroGas Investment Inc. ("**CPII**"), a Canadian holding company, which itself owned 100% of the shares of CanaSea Oil and Gas Ltd. ("**COGL**"), a Saskatchewan corporation. COGL was the only operating entity in the CanaSea Group, and held the major assets of the CanaSea Group, including certain petroleum and natural gas licences.

At the *ex parte* hearing to obtain the initial order, the applicants provided what they purported to be unaudited financial statements and represented to the Court that the entities were eligible for CCAA protection because they: (i) had liabilities in excess of $5 million; (ii) were unable to meet their obligations as they came due; and (iii) had finances that were "inextricably intertwined" through intercompany advances. This last point was particularly important, as COGG – one of the Singaporean corporations – was the issuer of certain notes representing 49% of the CanaSea Group's overall outstanding debt. The applicants alleged that COGG's two Canadian subsidiaries, CPII and COGL, were "on the hook" for these notes due to the intercompany obligations.

Two creditors holding these notes issued by COGG subsequently brought a motion to remove COGG from the CCAA proceedings. Among other things, they argued that Ontario courts lacked the statutory jurisdiction to issue the initial order in respect of COGG. The moving creditor group wished instead to pursue its rights and remedies under the notes in Singapore, as per the terms of the notes.

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[1] Ian Aversa is a partner in the Financial Services Group and Jeremy Nemers is an associate in the Financial Services Group. The authors would like to thank Stephen Crawford, a student-at-law at Aird & Berlis LLP, for his assistance in preparing this paper.
[2] *Re CanaSea Petrogas Group Holdings Ltd.*, 2014 ONSC 6116 [*CanaSea*].
[3] *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 [CCAA].
[4] 2014 ONCA 824.

Upon the evidence produced by the creditors at the motion, most of which was obtained on the cross examination of the founder and director of the CanaSea Group, Justice Penny came to the conclusion that the initial order had been incorrectly issued. The evidentiary record only supported a finding that Holdings and the two Singaporean companies were insolvent and had liabilities in excess of $5 million – not CPII or COGL. There was no evidence of intercompany loan agreements, and CPII and COGL were not "on the hook" for COGG's notes – the entities in the CanaSea Group were not "inextricably intertwined." Further, the applicants had failed to disclose all financial statements prepared during the year before the application, as required under section 10(2)(c) of the CCAA; they had merely disclosed profit and loss statements and a general ledger, not the unaudited financial statements that had been prepared.

Overall, the applicants had failed to meet their "high obligations of candour and disclosure on an *ex parte* application," and the 'real' debtors in the proceeding, the Singaporean entities, had very little connection to Canada. As such, Justice Penny found it appropriate to declare the initial order *void ab initio*. Parties bringing *ex parte* applications should be mindful of these obligations when considering what evidence should be presented to the court to justify the relief sought. Further, in the context of applications for CCAA protection, the eligibility criteria must be met; it is insufficient to merely assert a related group of companies without providing evidence of intercompany loan agreements or other intercompany obligations.

Nortel and the "Interest Stops" Rule

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On January 14, 2009, Nortel Networks Corporation ("**NNC**") and other related Canadian entities filed for and obtained protection under the CCAA.[2] Nortel Networks Inc. ("**NNI**") and other related US entities concurrently filed petitions under Chapter 11 of the United States Bankruptcy Code. Certain unsecured *pari passu* notes were issued by NNC, NNI and other Nortel entities between 1996 and 2009, each note being severally guaranteed by NNC and NNI. In total, bondholders made claims in both the Canadian and US proceedings for principal and pre-filing interest of US$4.092 billion against each of the Canadian and US estates.

However, these bondholders have also claimed to be entitled to post-filing interest and related claims under the terms of the bonds. As of the end of 2013, these post-filing interest claims amounted to approximately US$1.6 billion. Given that the total assets realized worldwide on the sale of Nortel assets was approximately US$7.3 billion, these post-filing claims represented a significant portion of the total assets available for distribution to creditors. At a hearing before the Honourable Justice Newbould of the Ontario Superior Court of Justice (Commercial List) to determine the issue of whether the bondholders had rights to post-filing interest, the Court denied the bondholders' claims and sided with the objecting creditors, including former employees, disabled employees and retirees, citing the so-called "interest stops" rule.[3]

The "interest stops" rule is a common law rule that has been enshrined in statute under the BIA,[4] based on the fundamental principles of fairness and equality as between unsecured creditors in insolvency proceedings. While the CCAA is silent as to the right to post-filing interest, the objecting creditors successfully argued at the hearing that the rule should apply in the situation at hand because of the nature of this particular CCAA proceeding. Although CCAA proceedings are often used for the purpose of restructuring with an aim to continue the business as a going concern, the Nortel CCAA proceeding was, in reality, a "liquidating" CCAA proceeding.[5]

As such, Justice Newbould applied the "interest stops" rule to prevent the bondholders from claiming post-filing interest.[6] Citing the Supreme Court of Canada's decisions in *Century Services*[7] and *Indalex*,[8] His Honour interpreted the CCAA to strive for uniform treatment of creditors across insolvency regimes. This interpretation ensures that creditors will not choose to pursue liquidation through CCAA proceedings (rather than a liquidation proceeding under the BIA) for the sole purpose of achieving differential treatment of post-filing interest. Further, there

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[2] *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 [CCAA].
[3] *Re Nortel Networks Corporation et al*, 2014 ONSC 4777 at para 25 [*Nortel*].
[4] *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 [BIA].
[5] Courts in Ontario have recognized that the CCAA can be used for the purpose of liquidating assets and proceedings of this nature are not uncommon in Ontario.
[6] *Nortel, supra* note 3.
[7] *Century Services Inc. v Canada (Attorney General)*, 2010 SCC 60 [*Century Services*].
[8] *Sun Indalex Finance, LLC v United Steelworkers*, 2013 SCC 6 [*Indalex*].

are a number of policy reasons supporting the application of the "interest stops" rule, as it furthers the CCAA's objective of maintaining the status quo rather than allowing certain claims to grow disproportionately.

The bondholders advanced a number of arguments in support of their position. Justice Newbould rejected the idea that their contractual right under the bonds to post-filing interest was a property right, as the bonds were unsecured, citing *Thibodeau*[9] in support of this position. The bondholders also argued that it was premature for the court to rule on the post-filing interest issue in the absence of a plan of compromise or arrangement, but His Honour disagreed: the court was not compromising the bondholders' claims to post-filing interest in the absence of a plan, but instead was determining whether a claim to such interest existed pursuant to the claims procedure orders that were previously issued by the Court.

The bondholders also relied on the Court of Appeal for Ontario's decision in *Stelco*,[10] in which that Court stated that there was no persuasive authority supporting the application of the "interest stops" rule in a CCAA proceeding. However, His Honour distinguished this case on the basis that Stelco did not involve a claim for post-filing interest against the debtor, but rather involved a dispute between two classes of debenture holders.

Similarly, the bondholders relied on *Canada 3000*,[11] a case which involved an airline obtaining CCAA protection and the Monitor subsequently filing an assignment into bankruptcy on the airline's behalf three days later. The airline owed outstanding payments to certain airport authorities for the use of their facilities, and the airport authorities wished to seize certain aircraft that had been leased to the airline. The owners/lessors of the aircraft were found not to be liable for the outstanding payments, but nevertheless the airport authorities were allowed to seize and detain the aircraft until all amounts, including post-filing interest, were paid in full. At the Supreme Court, Justice Binnie briefly observed that a CCAA filing did not stop the accrual of interest.

Justice Newbould again distinguished this case on the facts, and noted that Justice Binnie's statement "should not be taken as a blanket statement that interest always accrues in a CCAA proceeding." His Honour noted that the Supreme Court had not analyzed the "interest stops" rule by considering the applicable common law and CCAA provisions, and viewed the statement as "simply conclusory" and possibly even "*per incuriam*." His Honour also noted that the amount of post-filing interest at issue in each case was vastly different and, once again, commented that these cases must be interpreted in light of the recent Supreme Court jurisprudence that indicates that creditors should receive similar treatment in BIA and CCAA proceedings.

An appeal to His Honour's decision has been argued at the Ontario Court of Appeal, and is currently reserved for judgment.

[9] *Thibodeau v. Thibodeau*, 2011 ONCA 110 [*Thibodeau*].
[10] *Re Stelco Inc.*, 2007 ONCA 483 [*Stelco*].
[11] *Re Inter Canadian (1991) Inc. (Trustee of) Canada 3000 Inc.*, 2006 SCC 24 [*Canada 3000*].

Professional Fees in Insolvency Proceedings

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Two recent Ontario Superior Court decisions, one of which was affirmed by the Court of Appeal for Ontario, imposed significant reductions in legal fees for court-appointed officers and their legal counsel on the basis that the amounts sought were unreasonable in consideration of the work performed. In *TNG Acquisition*[2] and *Diemer*,[3] the Honourable Justices Brown and Goodman, respectively, exercised their judicial discretion in scrutinizing the fees sought. Their analyses were guided by the principles of reasonableness and fairness. In performing these analyses, they followed the Court of Appeal's decision in *Bakemates*,[4] which held that the onus is on a receiver to demonstrate that the amount of its fees is fair and reasonable when the court's approval of fees is sought. This principle is further supported in *Belyea*,[5] in which the New Brunswick Court of Appeal held that a receiver's compensation must be a fair and reasonable measure of its services, and that those services should be administered as economically as possible.

Diemer (Ontario Superior Court of Justice)

In *Diemer*, a January 2014 decision, the Court was asked to approve the fees and disbursements of receiver's counsel in the amount of $255,955. In reducing this amount to $157,500, the Honourable Justice Goodman held that, notwithstanding the initial receivership order permitting the receiver's counsel to charge standard rates,[6] the fees charged were not appropriate given the nature of the receivership.

Justice Goodman took several factors into consideration, as listed at paragraph 9 of *Diemer*:

> (i) whether the nature and extent of the value of the assets handled have a linear relationship with the fees sought (in general, the lower the value of the assets, the lower the cost of administering the assets);
>
> (ii) whether there were complications or difficulties encountered during the receivership, as this would provide support for a claim for higher costs; and
>
> (iii) the cost of comparable services when performed in a prudent and economical matter.

In regards to factor (iii), His Honour noted that legal fees from London, Ontario lawyers were lower than their colleagues in Toronto, and since this receivership was administered in the

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[2] *TNG Acquisition Inc. (Re)*, 2014 ONSC 2754 [Commercial List] [*TNG Acquisition*].
[3] *Bank of Nova Scotia v. Diemer,* 2014 ONSC 365 [*Diemer*].
[4] *Bakemates International Inc. (Re)*, [2002] O.J. No. 3569 (Ont. C.A.).
[5] *Belyea v. Federal Business Development Bank*, [1983] N.B.J. No. 41 (N.B.C.A.).
[6] The relevant language in the order tracked the language contained in the Model Receivership Order.

London area, a representative London rate should be used for comparison purposes in examining the appropriateness of the fees claimed by the receiver's counsel.

Justice Goodman also commented that receiver's counsel had not updated the court on its accrued costs generated in supporting the receiver in administering the receivership, noting that while there is no obligation for receiver's counsel to seek the court's approval for fees on a routine basis, it would be prudent to do so in matters where costs are running high relative to the value of the assets being administered. The Court also took issue with the fact that senior partners did not delegate sufficiently in what His Honour regarded as a simple matter, where junior lawyers or staff could have competently performed the necessary work.

***Diemer* (Court of Appeal for Ontario)**

On December 1, 2014, in a unanimous decision written by Justice Pepall, the Court of Appeal for Ontario upheld Justice Goodman's decision.[7] The court-appointed receiver, as appellant, advanced three grounds of appeal and submitted that the motion judge erred:

> (i) by failing to apply the provisions of the appointment order, which entitled the receiver's counsel to charge fees at its standard rates;
>
> (ii) by reducing the receiver's counsel's fees in the absence of evidence that the fees were not fair and reasonable; and
>
> (iii) by making unfair and unsupported criticisms of counsel.[8]

The Court of Appeal dismissed the appeal, finding that the motion judge did not err in its reduction of the fees. While the Court found that certain of the facts were open to interpretation, it deferred to Justice Goodman's analysis, finding that the motion judge had drawn conclusions based on evidence from the record in order to conclude that the fees were not fair and reasonable. The Court of Appeal found that the relevant *Bakemates* principles and *Belyea* factors had been identified and applied in the motion judge's analysis. While the Court found there were some unfair criticisms made of receiver's counsel, it held that the motion judge's analysis resulting in the reduction of fees was appropriate.

TNG Acquisition

In *TNG Acquisition,* a May 2014 decision, a trustee in bankruptcy (the "**Trustee**") sought an order authorizing the former Chief Restructuring Officer to distribute costs to the company's Monitor (the "**Monitor**"), appointed under the CCAA,[9] and to the Monitor's legal counsel. The costs were associated with the Trustee's request relating to certain events which took place during the Monitor's appointment, and the retrieval of related documentation. The Honourable Justice Brown, then of the Ontario Superior Court of Justice (Commercial List), referred to this task as an "archive-retrieval request."

[7] *Bank of Nova Scotia v Diemer*, 2014 ONCA 851.
[8] *Ibid* at para 28.
[9] *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 [CCAA].

While His Honour found that the time spent to obtain, review and deliver the documentation was reasonable, the fees charged for such work were not. His Honour referred to the court's discretion to review the reasonableness of the fees charged and reduced the amount to be distributed.

Specifically, Justice Brown took issue with the seniority and rates of professionals tasked to complete the work, holding that if a partner or senior manager elects to perform work of a clerical or administrative nature, then he or she should bill at clerical or administrative rates. Counsel's fees, when "measured against the simplicity of the request," were held to render the submitted costs unreasonable.

Finally, the Monitor's charge of 9% of total costs, allocated to cover "administrative expenses", was found to be unreasonable. His Honour held that administrative costs are generally contemplated in the hourly rates of professionals, and as such, both the Monitor's and its counsel's costs were reduced.

Practical Application of *Diemer* and *TNG Acquisition*

Courts in Ontario have recently demonstrated an active willingness to exercise discretion in the approval of professional fees claimed in respect of bankruptcy and insolvency matters. Accordingly, professionals in this field should keep the following in mind:

1. Be careful and precise when preparing and providing information contained in fee affidavits. This applies to legal counsel as well as other professionals submitting such claims.

2. Ensure that work is performed by individuals with the appropriate skill level and billing rates for a particular task. Tasks should be delegated to the appropriate person for the task. Clerical and administrative tasks should not be performed by senior professionals, or, in the event that timelines or other factors necessitate that this work be performed by a more senior professional, appropriate rates should be applied that reflect the level of skill required for the work performed. In its decision, the Court of Appeal noted that "value should pre-dominate over the mathematical calculation reflected in the hours times hourly rate equation."[10] Value appears to drive the Court of Appeal's analysis of fairness and reasonableness, as "the focus of the fair and reasonable assessment should be on what was accomplished, not on how much time it took."[11]

3. Regularly seek approval of professional fees and disbursements as proceedings progress. While a motion specifically for the approval of professional fees seems unnecessary, regularly seeking fee approval in motions for other substantive relief seems appropriate.

4. The practice of allocating administrative expenses as line items in invoices to account for general overhead expenses may need to be revised or eliminated. Justice Brown noted that 9% of total costs is unreasonable and should instead be reflected in the hourly rates charged.[12] Professional service providers may need to review the manner in which these

[10] *Ibid* at para 45.
[11] *Ibid* at para 45.
[12] *TNG Acquisition, supra* note 2 at paras 19-20.

costs are defrayed in order to ensure that they can be recaptured without the possibility that the Court will refuse to approve such costs.

5. Geographic location (for the purposes of generating comparative local professional fees) and the nature of the proceedings are factors that will be considered when fees are reviewed in order to determine whether the assets are being administered as economically as possible.

6. The Court of Appeal confirmed that *Bakemates* enunciates appropriate principles to be applied when passing accounts, and *Belyea* identifies relevant factors to be considered – but this list of factors is not exhaustive. *Bakemates* further confirms that the onus is on the receiver to prove that the compensation for which it seeks approval (including on behalf of its counsel) is fair and reasonable, and that an analysis of such fees will focus on issues of fairness and reasonableness.

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