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Corporate insolvencies

The current economic environment has created a number of business casualties. Corporate insolvencies often require in-house counsel to confront a variety of complex and frequently real-time legal issues. Take the following quiz by Paul D. Guy, an associate with WeirFoulds LLP, whose practice includes bankruptcy and insolvency litigation.

1 A company declares bankruptcy and terminates the employment of all its employees without paying any wages that were earned during the last month of operation, or any vacation or severance pay. The total liquidation value of all the company's assets is $3 million. Secured creditors are owed more than $4 million. As a result, employees will recover nothing.

True or False?

2 The nature of the fiduciary duty owed by a corporation's directors and officers shifts when the company approaches insolvency, requiring that the interests of the company's creditors now be paramount.

True or False?

3 You are in-house counsel at a corporation. The company is facing a serious short-term cash crunch and is not going to be able to make payments owed to bondholders at the end of the month. The company's first-ranking secured creditor, Big Bank, holds a demand loan that stands at $15 million. As security for its loan, Big Bank is the beneficiary of a general security agreement that covers all of the company's assets (which are currently worth less than the $15 million owed to Big Bank). The company has asked Big Bank to lend it a further $3 million to get it through the next six months. Big Bank has refused. A second lender, Distressed Private Equity, is prepared to advance the required funds, but only if it is able to obtain security that would put it ahead of Big Bank. This is not possible and, unless Big Bank has a change of heart, the company will have no option but to declare bankruptcy.

True or False?

4 The following are sources of potential personal liability for directors of an insolvent company:

(a) tax statutes that require source deductions such as GST;
(b) statutes for the protection of the environment;
(c) statutes that protect employees; or
(d) all of the above.

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QUIZ ANSWERS

A 1. FALSE.

This would have been true in the past. The proceeds from the company's estate would be insufficient to pay any employee claims because the claims of secured creditors, which rank ahead of any employee claims, are greater than the value of the estate. Things changed, however, with the introduction of the Wage Earner Protection Program (WEPP). The WEPP is a new Government of Canada program that is designed to use government funds to satisfy claims of eligible workers, up to prescribed maximum amounts, for unpaid wages, vacation pay, severance pay, and termination pay owed to them when their employer declares bankruptcy or becomes subject to a receivership. Because payments to eligible employees come from the WEPP fund, as opposed to the estate, prior ranking secured claims are not an issue. But there are several restrictions. For example, officers and directors are excluded; it only covers wages that were earned during the six months prior to the bankruptcy or receivership; and benefits are currently capped at $3,250 or the equivalent of four weeks maximum insurable earnings under the Employment Insurance program. Secured creditors are also affected because the government has a subrogated claim against the estate in respect of any payments made from the fund, and such claims are granted a limited super priority ahead of secured creditors up to $2,000 per employee to be paid out of the proceeds of the company's current assets (defined to include cash, inventory and accounts receivable).

A 2. FALSE

This idea was considered and rejected by the Supreme Court of Canada in *Peoples Department Stores Inc. (Trustee of) v. Wise, [2004] 3 S.C.R. 461.* The court held that at all times directors and officers owe their fiduciary obligations to the corporation, and that the interest of the corporation is not to be confused with the interests of the creditors or any other stakeholder. But the court did say that while directors and officers must always consider the best interests of the corporation, it may also be appropriate, given the circumstances of a given case, to consider the impact of corporate decisions on a variety of potential stakeholders, including shareholders, employees, suppliers, creditors, consumers, governments and the environment.

A 3. FALSE.

The company could file for protection under the Companies' Creditors Arrangement Act (CCAA) and seek approval for a DIP (debtor-in-possession) loan with Distressed Private Equity. A DIP loan is designed to facilitate the restructuring of an insolvent company by allowing it to obtain required short-term financing that is granted priority over existing security held by other creditors (up to a capped amount). DIP loans are common to CCAA proceedings and are normally authorized in the initial order granting a distressed company protection from its creditors under the CCAA.

A 4. ALL OF THE ABOVE.

Directors of insolvent companies face potential personal liability from a wide variety of sources. Each case will raise unique facts and issues. Directors should not assume they are covered by director and officer (D&O) insurance, and they should take the potential for personal liability seriously. In many (but not all) cases, directors will have a "due diligence defence" against potential claims.

YOUR RANKING?

- **One or fewer correct:** *Might be time to brush up*
- **Two or three correct:** *Not bad, but could do better.*
- **Four correct:** *Impressive.*