

Canadian Ruling Favors Third-Party Releases

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In a landmark decision of the Ontario Superior Court of Justice released June 5, 2008, the court confirmed a plan of arrangement under the Companies' Creditors Arrangement Act (CCAA) that restructures approximately \$33 billion of debt relating to a third-party asset-backed security (ABCP) in Canada.



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The case is unusual for a number of reasons. The applicants were a group of holders of ABCP representing \$21 billion of notes who sought to have 20 ABCP conduits placed within the protection of the CCAA in order to

restructure the conduits. While the total ABCP market in Canada is approximately \$116 billion, this includes ABCP issued by banks. The 20 conduits in this case are substantially all of the issuers of third party (*i.e.*, nonbank) issued asset back commercial paper in Canada, in the total amount of approximately \$33 billion Canadian (the Canadian dollar is currently approximately on par with the U.S. dollar). The only nexus among the conduits of unrelated sponsors was that they had issued the third party ABCP.

The second, and arguably the more unusual, aspect of this case, is that the plan provides for a broad, blanket release from any and all claims against not only the conduits and the sponsors, but any other person, including dealers, liquidity providers, rating agencies and issuer trustees. In essence, any claims that could be made against any person, not just the conduits, for any damages suffered have been wiped out with one carved-out exception.

The third unique aspect of this case is the speed with which this restructuring has been proceeded. While the situation arose in August 2007, the initial order under the filing did not occur until March 17, 2008. In less than three months since the date of filing (less than nine months since the collapse of the ABCP in Canada), the parties involved have obtained court approval for the largest and most complex restructuring in Canadian history.

About the Author

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Background

In response to the collapse of the ABCP market in the second week of August 2007, various industry representatives, asset providers and liquidity providers entered into a standstill

(also known as synthetic assets) in the form of credit default swaps. Some of the assets of the conduits are comprised exclusively of traditional assets, some are exclusively synthetic, and some are mixed. A majority of the synthetic assets are leveraged super senior swaps. The concern with respect to these forms of assets is that if there was a margin call, and the additional collateral was not posted, the asset provider would have the right to terminate the swap and satisfy any termination payment that was then due by enforcing its security (the asset providers typically have security which is in priority to the ABCP). This could have the effect of causing the value of the security to plummet, depending on market conditions at that time.

The International Scene

Little detailed information has been made public on the underlying assets in

agreement and committed themselves to restructuring the ABCP under an agreement of Aug. 16, 2007, which has come to be known as the "Montreal Accord." After considerable lengthy and difficult negotiations among the various stakeholders, including sponsors, noteholders, liquidity providers, asset providers, agents, dealers, Canadian banks, investment houses, foreign banks and financial institutions, etc., a plan was developed to have all conduits file for protection under the CCAA. ABCP typically has short term maturity dates. The underlying assets in the conduits typically have long-term maturation. Thus, the goal of restructuring the ABCP was to provide for a matching between the term of the new notes to be issued in exchange for the existing short-term ABCP and the maturity of the long-term underlying assets in the conduits.

As each conduit contained a different mix of assets, this was a nontrivial challenge. The facts surrounding the filing are discussed in an affidavit filed in connection with the application for the initial order under the CCAA.¹

Some assets backing the ABCP consist of traditional financial assets, including credit card receivables, equipment leases, auto loans, mortgages, corporate loans, etc. However, the majority of the assets (over \$26 billion) are in the form of derivative contracts

¹ [7] Before the week of August 13, 2007, there was an operating market in ABCP. Various corporations (referred to below as "Sponsors") arranged for the Conduits to make ABCP available as an investment vehicle bearing interest at rates slightly higher than might be available on government or bank short-term paper.

[8] The ABCP represents debts owing by the trustees of the Conduits. Most of the ABCP is short-term commercial paper (usually 30 to 90 days). The balance of the ABCP is made up of commercial paper that is extendible for up to 364 days and longer-term floating rate notes. The money paid by investors to acquire ABCP was used to purchase a portfolio of financial assets to be held, directly or through subsidiary trusts, by the trustees of the Conduits. Repayment of each series of ABCP is supported by the assets held for that series, which serves as collateral for the payment obligations. ABCP is therefore said to be "asset-backed."

[9] Some of these supporting assets were mid-term, but most were long-term, such as pools of residential mortgages, credit card receivables or credit default swaps (which are sophisticated derivative products). Because of the generally long-term nature of the assets backing the ABCP, the cash flow they generated did not match the cash flow required to repay the maturing ABCP. Before mid-August 2007, this timing mismatch was not a problem because many investors did not require repayment of ABCP on maturity; instead, they reinvested or "rolled" their existing ABCP at maturity. As well, new ABCP was continually being sold, generating funds to repay maturing ABCP where investors required payment. Many of the trustees of the Conduits also entered into back-up liquidity arrangements with third-party lenders ("Liquidity Providers") who agreed to provide funds to repay maturing ABCP in certain circumstances.

[10] In the week of August 13, 2007, the ABCP market froze. The crisis was largely triggered by market sentiment, as news spread of significant defaults on U.S. subprime mortgages. In large part, investors in Canadian ABCP lost confidence because they did not know what assets or mix of assets backed their ABCP. Because of this lack of transparency, existing holders and potential new investors feared that the assets backing the ABCP might include subprime mortgages and other overvalued assets. Investors stopped buying the new ABCP, and holders stopped "rolling" their existing ABCP. As ABCP became due, Conduits were unable to fund repayments through new issuances or replacement notes. Trustees of some Conduits made requests for advances under the back-up arrangements that were intended to provide liquidity; however, most Liquidity Providers took no position that the conditions to funding had not yet been met. With no new investment, no reinvestment, and no liquidity funding available, and with long-term underlying assets whose cash flows did not match maturing short-term ABCP, payments due on the ABCP could not be made—and no payments have been made since mid-August.

each conduit. In fact, only general information has been made available to noteholders of each conduit (subject to nondisclosure agreements). While it is therefore impossible to say what the value is of underlying assets in each conduit, JPMorgan was engaged as financial advisor to review the value of the assets in the conduits and provide financial advice. A report filed by JPMorgan indicates that the trigger default risk at March 4, 2008, was about 94 percent. Thus, more than \$15 billion of collateral was at risk of seizure.

The court made the initial order on March 17, 2008, and granted the conduits the protection afforded to applicants under the CCAA. On the same date, the court also made an order scheduling a meeting of noteholders and providing for the manner of notice thereof, including sending (what had by then become) an amended plan of compromise. A detailed information statement describing the plan was also distributed. Neither of these orders was appealed.

Prior to the meeting of the noteholders scheduled for April 25, 2008, a motion was brought by various noteholders seeking a change in classification (the plan provides one vote per noteholder), provision of various information, adjourning the vote until these issues were resolved and amending the plan to delete various parties from the broad releases granted under the plan.

On the day before the note holders meeting, the court released its decision. The court was not prepared to allow the vote to be adjourned and was satisfied that the monitor would be able to tally the votes in a manner that the issue of classification could be dealt with on the fairness hearing for plan approval.

The court was confident that certain of the information in question would be provided, particularly as to the development outside of the plan of protection for noteholders who had less than \$1 million of notes who purchased notes from certain dealers. In essence, certain dealers agreed to purchase the customers' ABCP or to extend financing assistance. Obviously, these arrangements were designed to obtain a successful result under a plan (which requires two-thirds in dollar but also 50 percent in number of those voting on the plan). The purchase of these notes assisted in increasing the number of votes in favor of the plan. This point was made repeatedly in court on the motion that the vote in favor of the plan would be a

foregone conclusion by reason of this purchase outside of the plan.

The Vote and the Fairness Hearing

On the fairness hearing, it was clear that the financial terms of the plan were not an issue. The court found that if the plan did not go forward, the value of notes was "highly uncertain." The court also found that the result of the vote of creditors was overwhelmingly in favor of the plan—by 96 percent.

The significant issue for the court on the hearing was therefore the breadth and scope of the releases granted in the plan in favour of not just the conduits, but diverse interests including dealers, banks, conduits, liquidity providers, financial institutions, rating agencies, etc. The plan provided for release from contractual, negligence and fraud claims against the various potential defendants.

The Release and the Carve-out

In an endorsement released on May 16, the court did not sanction the plan, adjourned the sanction hearing and expressed some reservations about the scope of the release in the plan. There was concern about whether it could sanction a plan that provided for a broad release from potential fraud claims. The court asked the parties to develop a mechanism for the court to determine in an expeditious fashion whether or not the plan could be approved with a way to take into account legitimate, specific and particularized claims of fraud, if any.

In the material filed in support of the plan, it was indicated that the releases were integral to the plan. In an effort to address the issues raised by the court, various stakeholders had negotiated a "carve-out" from the release.

While the terms of the carve-out are quite detailed, certain claims are not precluded from being pursued by certain potential plaintiffs. A potential plaintiff must have suffered damages as a direct result of purchase of ABCP in reliance on an express fraudulent misrepresentation relevant to such ABCP. The fraudulent misrepresentation must have been made by the dealer who sold the ABCP at the time of purchase, which was made with intention of inducing plaintiff to purchase—and the dealer must have known the misrepresentation to be false. Under the terms of the carve-out, the dealer is precluded from asserting a claim over against other participants in the ABCP market.

While costs normally follow the event

in Canada, these are usually on a basis of less than full indemnity (the amount varies from province to province and can vary with the facts and the conduct of the case). In connection with claims under the carve-out, a successful litigant is entitled to full indemnity costs.

In its reasons for judgment, the court carefully reviewed the law concerning noninsolvent third-party releases in Canada in the context of CCAA plans. There are very few cases that discuss the issue, particularly for releases for persons other than the debtor and its officers and directors.

The court had also asked the parties to provide the monitor with information so that it could compile a list of existing or potential claims against third parties, including conduits and their trustees. The list prepared by the monitor indicated that the primary defendants were or were anticipated to be banks and dealers. The claims would be mainly in tort, including negligence, misrepresentation, negligent misrepresentation, failure to act prudently as dealer/adviser, acting in a conflict of interest and, in a few instances, fraud or potential fraud.

The court noted that this restructuring is not just a restructuring relating to the conduits in question, but in reality is a restructuring of the \$33 billion third-party ABCP market in Canada. However, given the nature of the ABCP market, the court thought it appropriate to consider the noteholders as claimants, and the object of the plan to restore liquidity to the assets (the notes), which requires participation of all noteholders.

While the court was urged to conclude that it had the power to amend the plan, it was of the view that it did not. It also found that absent the releases in question, the plan would fail and there would be no reliable prospect that the plan would be revised.

The court was of the view that it had the authority to sanction a plan that gave third-party releases for negligence. This was based, in part, on the recent Canadian CCAA/U.S. chapter 15 case of *Muscletech*, which provided for broad releases in favor of third parties, although there was no opposition to such releases at the sanction hearing in *Muscletech*. The court noted that the potential claims are directly related to the value of the notes. The persons being released are "directly involved in the Company" and many of them are foregoing immediate rights to assets and

continued on page 87

The International Scene: Canadian Ruling Favors Third-Party Leases

from page 41

providing real input for the enhancement of the notes. Thus the court concluded it had authority to sanction the plan with the releases of negligence.

As many other courts have done, the court adopted a purposive approach to interpretation of the CCAA, and found that a hierarchical method was appropriate—statutory interpretation (gap filling under the CCAA), judicial discretion and use of inherent jurisdiction. Justice Campbell indicated:

While the court was urged to conclude that it had the power to amend the plan, it was of the view that it did not. It also found that absent the releases in question, the plan would fail and there would be no reliable prospect that the plan would be revised.

[102] It simply does not make either commercial, business or practical common sense to say a CCAA plan must inevitably fail because one creditor cannot sue another for a claim that is over and above entitlement in the security that is the subject of the restructuring, and which becomes significantly greater than the value of the security (in this case the Notes) that would be available in bankruptcy. In CCAA situations, factual context is everything. Here, if the moving parties are correct, some creditors would recover much more than others in their security.

[103] There may well be many

situations in which compromise of some tort claims as between creditors is not directly related to success of the Plan and therefore should not be released; that is not the case here.

The court then turned its mind to the carve-out, which, as noted above, limits causes of actions to those against dealers. The objectors to the plan postulated that the narrow nature of the carve-out precluded recovery in circumstances where senior bank officers with fraudulent intent directed sales persons to make statements that the sales person reasonably believed, but that the senior officers knew to be false. The court indicated that even if that were the case, the plan should not be rejected on the basis that the carve-out is not as broad as it could be.

The court noted that the initial release provision compromised all fraud claims, and that it was aware that when it requested further consideration of the release that any carve-out would not be broad enough to include all possible future deceit or fraud claims. Rather, the concern was not to release claims arising from false representation knowingly made directly to noteholders who relied on the fraudulent misrepresentation and suffered damage as a result. The court concluded that the carve-out accomplished this purpose. The court found that the plan represented a reasonable balance between the benefit to noteholders and enhanced recovery for those who could make out specific claims in fraud.

In summary, the court put forward a number of questions that it was of the view must be answered in the affirmative in order to justify third-party releases within the CCAA context:

1. Are the parties to be released necessary and essential to the

restructuring of the debtor?

2. Are the claims to be released rationally related to the purpose of the plan and necessary for it?

3. Can the court be satisfied that without the released the plan cannot succeed?

4. Are the parties who will have claims against them released contributing in a tangible and realistic way to the plan?

5. Is the plan one that will benefit not only the debtor but creditor noteholders generally?

6. Have the voting creditors approved the plan with knowledge of the nature and effect of the releases?

7. Is the court satisfied that in the circumstances the releases are fair and reasonable in the sense that they are not overly broad and not offensive to public policy?

The court was able to answer all of these in the affirmative in this case; it therefore sanctioned the plan.

Conclusion

This case represents the largest restructuring in Canada to date, and is a landmark case in the granting of releases in favor of solvent third parties in the context of the CCAA. The issue of the appropriateness of the granting of such broad third-party releases to persons other than directors and officers, including certain releases for fraud, has now been judicially considered and explored in a comprehensive and thoughtful decision. It will be interesting to see the effect, if any, that this has on the ABCP in Canada. However, there is no doubt that this decision will assist the various stakeholders to bring greater stability and certainty to their positions and will allow them to move forward. ■