Waël Rostom
Andrew Kent
McMillan Binch Mendelsohn LLP

Introduction

This article provides a brief overview of some legal issues that impact claims trading in Canada.

Claims trading in Canada for the most part involves issues and practices that are substantially similar to the US. For example, in recent years many Canadian financial institutions have become comfortable trading Canadian syndicated loans using the standard documentation prepared by the Loan Syndications and Trading Association. Also, trade claims in Canada are often sold on forms of agreements developed in the US claim trading market (however, there is currently no standard form in this area).

It is important to note, however, there are differences between Canadian and US laws that can impact the trading of claims governed by Canadian law. This article focuses on some of these differences.

Background

Claims trading involves interested buyers purchasing the claims held by a person against a debtor or obligor. Common examples include: (a) bonds and other exchange traded debt securities (collectively, "Publicly Traded Securities"); (b) syndicated loans, private loans and positions in structured finance products such as structured equipment leases ("Loans"); (c) claims for goods or services provided to the business, including claims of trade suppliers and employees ("Trade Claims"); and (d) less commonly, unliquidated contingent claims or litigation claims (which pose unique challenges discussed below) (collectively, "Litigation Claims").

Sellers can be motivated by a number of factors, including: a view that the claim is overvalued, a desire to monetize the claim to avoid further monitoring and expenses to protect and enforce the claim, lack of clarity on future recovery and a desire for the certainty of immediate cash buyout. Regulated financial institutions may wish to sell a claim to simply remove it from their balance sheet due to capital requirements or because some regulatory or other restrictions prevent them from holding the type of consideration that may be issued to claim holders out of a plan of arrangement or proposal.

Buyers are also motivated by a number of factors, including: a view that the claim is undervalued; an opportunity exists to sell (or flip) all or part of the claim to one or more down-stream buyers for a profit; a strategic desire to amass sufficient claims against an insolvent debtor in order to influence or control the restructuring proceedings; or a belief that the class of claims will represent debt that may be converted to equity in a plan of reorganization of the debtor providing them with an ownership interest post-emergence.

Claims Trading Rules

Canada's two principal insolvency statutes are the Companies' Creditors Arrangement Act ("CCAA") and the Bankruptcy and Insolvency Act ("BIA"). Unlike section 3001 of the *US Bankruptcy Code* which sets out procedures for the assignment and recognition of claims, Canadian bankruptcy and insolvency legislation is generally silent on the issue. For example, in Canada there is no statutory protection similar to that found in Section 3000(e) of the *Bankruptcy Code* which prevents third parties from objecting to the transfer of a claim.

Accordingly, in Canada there is no formal recognized mechanism for the assignment and recognition of the transfer of claims in insolvency proceedings. As a matter of practice, however, ad hoc systems have been put in place to facilitate trading of claims in most of the large Canadian insolvency proceedings. However, there is no universally accepted structure that is adopted in all cases.

The BIA contains one rule which prevents the splitting of a claim for voting purposes. It provides that if a claim is purchased after bankruptcy, the buyer cannot vote unless the entire claim is purchased. It seems likely that this rule does not apply in a CCAA proceeding.

Canadian Securities Laws

In Canada, securities laws are governed by provincial laws and each province regulates trades and distributions of securities in that province. The securities laws of the provinces in Canada are for the most part conceptually substantially similar to US securities laws. However, there are important differences including the treatment of insiders or persons in a "special relationship" with reporting issuer of securities.

It is clear that Publicly Traded Securities (such as bonds, debentures or notes) are securities and trades in these claims are regulated by Canadian securities laws. It is doubtful that Litigation Claims would constitute a security. However, there is uncertainty in Canada whether claims such as Loans or Trade Claims are securities for the purpose of securities laws. The form of the documentation used to evidence the Loans or Trade Claims could affect the legal analysis.

The consequences of a "claim" being treated as a "security" include that certain registration and prospectus requirements under securities laws would apply. The registration requirement provides that a person shall not trade in a security or act as an advisor unless appropriately registered (i.e. licensed) or in reliance upon a registration exemption. While most sellers and buyers of Loans would likely qualify under the "accredited investor" exemption to both the registration and prospectus requirements, this is not necessarily the case with sellers of Trade Claims.

Another consequence of a claim being

a security is that insider trading rules would apply. The insider trading rules under Canadian securities laws only apply to debtors that are public issuers and in respect of trades in the issuer's publicly traded securities. However, Canada's corporate statutes also contain insider trading rules that apply to private corporations.

By way of example, the Ontario Security Act ("OSA") insider trading provisions apply to persons in a "special relationship" with the reporting issuer. The definition of "special relationship" is very broad. No person in a special relationship with the reporting issuer can purchase or sell securities of the reporting issuer with the knowledge of a material fact or material change with respect to the reporting issuer that has not been generally disclosed.

Significantly for claims trading, it also captures tipping and chain-tipping. For example, the definition of special relationship includes a person or company that learns of a material fact or material change with respect to the issuer from any other person or company, and knows or ought reasonably to have known that the other person or company is a person or company in a special relationship with the reporting issuer. A consequence is that if a person learns of a material fact or material change, that person is restricted from trading until the information becomes generally disclosed.

Similar insider trading rules can apply to trades in claims against private corporations under applicable corporate laws.

Creditor's Committees

Canada's insolvency and restructuring laws, unlike the US *Bankruptcy Code*, do not currently include provisions that expressly enable the formation of either formal or ad hoc creditor committees. However, in larger cases informal creditor committees are routinely formed and commonly recognized by the courts. There are no express provisions in Canada's insolvency and bankruptcy laws that require members of committees to disclose their identity, holdings of claims and the price paid to acquires the claims. However, if a committee actively participates in an insolvency proceeding, it may become difficult to withhold information concerning the identity of the members of the committee and the size of their holdings.

Champerty and Maintenance

Buyers of claims need to be aware of the prohibition in common-law Canadian provinces against maintenance and champerty and, in the province of Québec, of the rules relating to "litigious rights."

An assignment of claim subject to Canadian common law is unenforceable if it involves maintenance or champerty. The rules are primarily meant to restrict the assignment of Litigation Claims where the assignor would not have pursued the claim, the assignee has no valid business purpose or prior connection to the litigation and is involved only to make a profit. An assignment of a liquidated debt claim such as Publicly Traded Securities or Loans are not generally subject to the rules against maintenance and champerty.

A recent Ontario Court of Appeal decision in *McIntyre Estate v. Ontario (Attorney General)*[2] provided a definition of maintenance and champerty. Maintenance is against those who, for an improper motive, often described as wanton or officious intermeddling, become involved with disputes (litigation) of others in which the maintainer has no interest whatsoever and where the assistance he or she renders to one or the other party is without justification or excuse. Champerty is a form of maintenance in which there is the added element that the maintainer shares in the profits of litigation.

The leading decision on champerty is *Fredrickson v. Insurance Corp. of British Columbia*.[3] Justice McLachlin (as she then was) reviewed the case law on the assignability of causes of action in contract and concluded that champerty and maintenance could be found if only the right of action in contract was assigned and the assignee had no genuine, pre-existing financial interest in the enforcement of the claim.[4] Justice McLachlin also reviewed English and Canadian and held that a cause of action in debt can be assigned, even if the debtor denies liability.[5]

Where applicable, the principles of champerty and maintenance could render a trade of Litigation Claims unenforceable.

"Litigious Rights"

The *Civil Code* of Québec has a provision, based on a policy of avoiding traffic in litigious claims (Champerty), under which a debtor of a purchased litigious claim can obtain a discharge of the claim by paying the purchaser the amount paid by the purchaser for the claim. A claim is defined as being litigious when it is uncertain, contested or contestable by the debtor.

A recent judgment of the Québec Superior Court in *Minco-Division Construction Inc. v. 9170-6929 Québec Inc.*, [2007] Q.J. No. 449, rendered in the context of the CCAA reorganization, has raised some issues about the scope of the application of this rule. The facts of the case are complicated and generally involved a "white knight" that agreed with the principals of the insolvent debtor to buy out its existing secured creditor's position and to support the debtor's reorganization plan. After the purchase, a falling-out occurred between the "white knight" and the debtors subsequent to which there was a dispute over whether or not the purchaser could participate in the CCAA proceedings for the full amount of the purchased claim.

After a lengthy hearing with contradictory evidence, the court

concluded that as a factual matter the parties had agreed that the purchaser, acting as what the court characterized as a "white knight," had agreed to limit its claims to the purchase price paid for the secured claims. Unfortunately, the Court went on to buttress the result by stating that the "value" of the claim was the amount paid for it to the secured lender based on estimated realizations and it was, therefore, an uncertain amount and qualified as a "litigious right" even though the face amount of the secured creditor's claim was never in dispute or contested. It is hoped that this decision will be restricted to its unusual facts.

Conclusion

The Canadian legal environment is generally facilitative of claims trading. While it is not as developed as the US market, it does continue to evolve and adapt to the developments in the US market. However, there are differences between the Canadian and US legal systems which should be taken into account when trading in Canadian claims. n

1. Written by Waël Rostom and Andy Kent, both partners of McMillan Binch Mendelsohn LLP practicing in the areas of corporate restructuring and debt products. The authors would like to recognize the contribution in respect of Québec law matters by Max Mendelsohn, a partner, and Marc-André Morin, an associate, in the firm's corporate restructuring group and based in the firm's Montréal office.
2. *McIntyre Estate v. Ontario (Attorney General)* (2002), 218 D.L.R. (4th) 193 at para. 27.
3. [1986] 4 W.W.R. 504 (B.C. C.A.); affrmd. [1988] 1 S.C.R. 1089 (S.C.C.).
4. *Ibid*. at para. 52.
5. *Ibid*. at para. 56.

Insolvency & Financial Restructuring

RECENT DEVELOPMENTS OF IMPORTANCE

Waël Rostom, *McMillan Binch Mendelsohn LLP*
Tel: (416) 865-7790 • Fax: (647) 722-6736 • E-mail: wael.rostom@mcmbm.com

A partner of the firm's Corporate Restructuring Group. Rostom has a commercial practice focusing on bankruptcy and insolvency, corporate restructurings, workouts, financings, secured lending transactions, the purchase and sale of distressed businesses and distressed loans and other forms of distressed investing, including DIP financings. Involved in numerous high-profile domestic and cross-border insolvency and restructuring proceedings. Advised banks, financial institutions, hedge funds, private equity funds, asset-based lenders, directors and officers, shareholders, customers and suppliers in significant restructuring proceedings. Also advised privately appointed and court-appointed receivers, trustees in bankruptcy and court-appointed monitors in properly and effectively discharging their statutory and other duties. Member of American Bankruptcy Institute, Turnaround Management Association, Loan Syndications and Trading Association – Firm Representative.

Andrew J. F. Kent, *McMillan Binch Mendelsohn LLP*
Tel: (416) 865-7160 • Fax: (647) 722-6715 • E-mail: andrew.kent@mcmbm.com

Andrew Kent is chair of the firm's Debt Products and Restructuring Group. He practices business law with a focus on corporate restructuring, lending, and private mergers and acquisitions. Recognized nationally and internationally both as a leading Canadian banking practitioner and as one of Canada's pre-eminent restructuring practitioners. A key participant in the development of DIP lending in Canada. He is experienced in cross-border financings and insolvencies, and international matters. Has led professional efforts to reform Canada's business insolvency laws serving as Chair of the Joint Task Force of the IIC and the CAIRP on Business Insolvency Law Reform and has written and lectured on statutory reform, reorganizations, directors' duties, secured and unsecured lending and guarantees. Member; CBA, IBA, IIC and ABI. Rated as AV by Martindale-Hubbell and listed in *Lexpert®/ALM Guide to the Leading 500 Lawyers in Canada* and *100 Most Creative Lawyers in Canada*. Graduated University of Toronto – BA, 1973; JD, 1976. Ontario Bar – 1979.