corporate restructuring bulletin

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Court clarifies elements of new interim financing rules

Cow Harbour Construction Ltd.[1]

introduction

The 2009 amendments to the *Companies' Creditors Arrangement Act* (Canada) (the "CCAA") and the *Bankruptcy and Insolvency Act* (Canada) codified with some modifications judge made law giving a court authority to grant super-priority priming liens to secure interim financing (or debtor-in-possession financing).

One of the modifications is that one of the new provisions, section 11.2(1) of the CCAA, expressly prohibits the court ordered security or charge from securing an obligation that exists before the order is made. Since the new language was introduced, insolvency professionals have speculated privately about how the courts might interpret this prohibition. They also wondered about the implications for structuring and availability of interim financing.

The decision of the Alberta Court of Queen's Bench in the CCAA proceedings involving *Cow Harbour Construction Ltd*. has shed some light on the interpretation of section 11.2(1) of the CCAA. In summary, the Court came to the following conclusions in this case:

1. section 11.2(1) is to be interpreted narrowly and literally to prohibit extending the security or charge to the pre-filing obligations; and
2. so long as the interim financing is used to fund the operations and restructuring of the debtor, section 11.2(1) is not violated by collections of pre-filing and post-filing receivables being used to permanently reduce the balance of a secured pre-filing working capital line.

As an aside, the Court objected to the use of the U.S. term "debtor-in-possession" or "DIP" financing. The court commented that the use of the term in Canadian proceedings is wrong from an American perspective

[1] *Cow Harbour Construction Ltd., Re* (28 April 2010), Edmonton 1003 05560, EVQ10COWHARB (Alta QB).

and inaccurate from a Canadian perspective. The Court preferred the term "interim financing" used in the CCAA.

discussion

Section 11.2(1) of the CCAA reads as follows:

On application by a debtor company and on notice to the secured creditors who are likely to be affected by the security or charge, a court may make an order declaring that all or part of the company's property is subject to a security or charge – in an amount that the court considers appropriate – in favour of a person specified in the order who agrees to lend to the company an amount approved by the court as being required by the company, having regard to its cash flow statement. The security or charge may not secure an obligation that exists before the order is made.

The intention of the prohibition appears to have been to eliminate the practice used by some secured creditors of requiring the cross-collateralization of pre-existing indebtedness with the super-priority interim financing lien as a condition of providing post-filing loans. Judges were often told that the consequence of not approving the cross-collateralization structure would be the denial of financing and immediate shut down of the business.

The lender in the Cow Harbour case did not even attempt to have the pre-filing working capital line obligations secured by the interim financing charge. In fact, the interim financing agreement expressly prohibited the use of the interim financing to repay or satisfy any indebtedness outstanding prior to the filing date.

The question at issue in the case was whether the pre-filing working capital facility inappropriately received the indirect benefit of the interim financing charge. Post-filing collections of accounts receivable that were generated prior to the filing date were to be applied to reduce the outstanding balance of the pre-filing working capital line. Those opposing the structure complained that this indirectly caused the secured lender's pre-filing obligations to be secured by the interim financing charge.

From the secured lender's perspective, however, this structure made commercial sense. The secured lender's pre-filing working capital line funded the pre-filing purchases and operations required to generate those same accounts receivable in question, not the interim financing. The working capital line was secured in first priority. If the lender permitted the accounts receivable collections to be used to fund the business, its collateral might well be burned up in the business and depleted for the benefit of other stakeholders. Accordingly, there should be no serious objection to this outcome in the vast majority of cases. This is especially true if arrangements have been made with the lender to (i) reimburse amounts received if its security for the pre-filing loans were subsequently determined to be unenforceable (to the extent an independent security opinion would not be obtained for the first day application), and (ii) deal with priority claims that existed at the time of receipt of the cash proceeds.

Interestingly, the Court also held that so long as the interim financing was used to fund continued operations and the cost of the case during the proceedings, the proceeds collected from accounts receivable generated after the filing date could also be used to pay down pre-filing working capital obligations. The court was of the view that the payments on the pre-filing working capital line were coming out of cash flow and not the interim financing directly. The court cited that the use of receivables in this manner did not violate the wording of section 11.2(1) of the CCAA.

This is sometimes described in U.S. cases as a "creeping roll" of the pre-filing obligations into the interim financing facility. While the interim financing grows as it is used to fund operations, the post-filing receipts are used to pay down the pre-filing working capital facility (potentially paying it out in full).

The Court's decision is good news to existing working capital lenders that are potential providers of interim financing. However, it is not yet clear whether other courts will follow the decision of the Alberta Court in Cow Harbour.

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a cautionary note

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