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allocation of restructuring costs: don't be caught by surprise!

The aggregate costs associated with a formal court-supervised insolvency proceeding can be substantial. In Canada, the obligation to pay these restructuring costs are typically secured by court-ordered charges over all of the property of the debtor and can rank in priority to the liens of secured creditors in the same collateral. As a result, these costs can have a material impact on the ultimate net recovery received by creditors. But how is the burden of these costs shared among secured creditors?

Canada's insolvency statutes do not deal with how the costs of the proceeding are to be allocated. It has been left for the court to exercise its discretion to allocate the burden of the costs among secured creditors' collateral proceeds on a case-by-case basis. Not surprisingly, allocation is a hot issue.

As a protective measure, secured creditors and equipment lessors should be cognizant of the cost allocation issue from day one of the insolvency case (including the terms of the first day orders) and how potential allocation of costs might inform their views on the case. Steps should be taken throughout the case to mitigate the risk of a cost allocation decision that is unexpected, or in the worst case, perceived by them to be unfair.

restructuring costs

The most common types of court-supervised insolvency proceedings where cost allocation issues have been litigated are either restructuring proceedings under the *Companies' Creditors Arrangement Act* ("CCAA") or court-supervised receivership proceedings where the assets or business have been sold and the appropriate share of the proceeds of realization must be distributed to the various creditors.

In CCAA cases, the restructuring costs incurred include: (a) the interim-financing (debtor-in-possession financing or "DIP" financing) used to fund the operations and restructuring costs of the debtor and secured by a super-priority, court-ordered priming lien on the property of the debtor, and (b) the professional fees and expenses of the court-appointed Monitor and the advisors to the debtor and the Monitor and secured by a super-priority, court-ordered priming lien on the property of the debtor (often referred to

as an Administration Charge). The costs in a court-supervised receivership include: (a) the professional fees of the court-appointed receiver and its advisors and agents and secured by a super-priority, court-ordered priming lien on the property of the debtor (often referred to as a Receivership Charge), and (b) the general costs of the receivership (e.g. costs of taking possession, carrying on the business and carrying out the receiver's duties such as running a sales process) – which can and are usually funded by resort to borrowings made by the receiver and secured by a super-priority, court-ordered priming lien on the property of the debtor (often referred to as Receiver's Borrowing Charge). The foregoing list oversimplifies the determination of the net costs in question but is sufficiently illustrative for this purpose.

current principles for cost allocation

The principles used by Canadian courts to guide the process of allocating the restructuring costs can be summarized as follows:[1]

- Each case is to be considered on its own facts;
- Costs that are incurred directly in connection only with specific collateral should be tracked and allocated only as against the proceeds from such collateral;
- Potential allocable costs not only include direct costs related to the preservation of and realization upon particular collateral but also the indirect general administrative costs of the relevant proceeding;
- The allocation of costs ought to be fair and evenhanded amongst all creditors upon an objective basis of allocation (i.e. fair and equitable basis);
- In many cases, the fairest basis of allocation would be for creditors to bear the general operating and restructuring costs in the same proportion as their individual recovery on their respective collateral compared to the total amount recovered (i.e. *pro rata* basis);
- Exceptions to a *pro rata* allocation should only be made where the requirement for such variation is reasonably articulable. Courts have noted that, while the proposed allocation must not ignore the benefit or detriment to any creditor, it does not require a strict accounting on a cost benefit basis or that the costs be borne equally or on a *pro rata* basis;[2]
- The allocation should take into account any differences in the nature of the debt giving rise to the claim, the nature and priority of the security and the remedies that were available to the secured creditor and the extent of its recovery;
- The allocation should not readjust the priorities between creditors;
- Costs of an insolvency proceeding can be allocated against that creditor's recovery but the creditor cannot be required to pay funds in excess of the value of its security interest;

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1 *Robert F Kowal Investments Ltd v Deeder Electric Ltd* (1975), 9 OR (2d) 84 (CA); *Re Hunters Trailer & Marine Ltd* (2001), 30 CBR (4th) 206 (Alta QB); *Re Hickman Equipment (1985) Ltd,* 2004 NLSCTD 164; *Re New Skeena Forest Products Inc,* 2005 BCCA 192; *Re Hunjan International Inc* (2006), 21 CBR (5th) 276 (Ont Sup Ct); *JP Morgan Chase Bank NA v UTTC United Tri-Tech Corp* (2006), 25 CBR (5th) 156 (Ont Sup Ct); *Re Stomp Pork Farm Ltd,* 2008 SKQB 179; *Re Winnipeg Motor Express Inc,* 2009 MBQB 204; *Re Respec Oilfield Services Ltd,* 2010 ABQB 277.

2 *Re Hunjan International Inc, ibid,* cited by *Re Winnipeg Motor Express Inc,* 2009 MBCA 110.

- The proposed allocation of the costs should generally be made at or near the conclusion of the proceedings; and
- The views of the Monitor or Receiver will be taken into account by the court but are not determinative. The allocation is ultimately in the court's discretion having taken into account the facts of the particular case.

examples of allocation in practice

Based on the decision in *Hickman* and cases that followed it, the starting point for a fair and equitable cost allocation appears to be that the secured creditors should bear the general operating and restructuring costs (costs that cannot be specifically allocated to one asset or one group of assets) in the same proportion as their individual recovery on their respective collateral compared to the total amount recovered. A secured creditor's recovery includes amounts received for an asset through a sales process and lease payments received for the use of leased equipment.[3]

A secured creditor's allocation of cost may deviate from a *pro rata* allocation of costs where it can demonstrate that there is an articulable reason for such a deviation.[4] Articulable exceptions for which the court has reduced a secured creditor's *pro rata* share of the restructuring costs include: a secured creditor holds collateral different in nature and priority, and possesses different remedies in respect of its collateral than other secured creditors; in respect of assigned leases, there is a risk of non-performance by the assignee of the lease; the secured creditor's assets are not sold in the sales process; and a *pro rata* allocation of costs will result in undue prejudice to the secured creditor. For example, the court has recognized that a financing lessor would experience undue prejudice if it did not receive any lease payments during the restructuring period but was required to pay a *pro rata* share of the general restructuring costs.[5] If the financing lessor received lease payments during the restructuring period, there would be no undue prejudice to the financing lessor if it was required to pay a *pro rata* share of the costs.[6]

A secured creditor should generally be able to avoid an allocation of indirect restructuring costs incurred after it has lawfully removed its collateral from the proceedings. However, in one case, where a guaranteed price was given for a creditor's collateral by an auctioneer prior to the removal of the collateral by the creditor, the creditor's deemed recovery for the purpose of determining its share of the costs was calculated using the guaranteed price of the asset and not the lower amount recovered by the secured creditor through its own sale process.[7]

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3 *Re Winnipeg Motor Express Inc, supra* note 1.

4 *Re Hickman Equipment (1985) Ltd, supra* note 1.

5 *Re Winnipeg Motor Express Inc, supra* note 1.

6 *Ibid.*

7 *Re Respec Oilfield Services Ltd, supra* note 1.

Lessors of equipment under a true lease (or operating lease) may be surprised to learn that even though their equipment is not property of the debtor, they may still be liable for a *pro rata* share of the restructuring costs.[8] During the restructuring period, true lessors are entitled to receive lease payments for the continued use of their equipment by the debtor company. However, if the court determines that a true lessor has received benefits (other than the lease payments to which they are entitled) through the restructuring process, they may be required to share in the restructuring costs. Benefits to a true lessor include having the debtor's interest in the leases assigned to and assumed by a new company, without interruption, through the work of the receiver or liquidator.[9]

conclusion

A secured creditor should consider certain enhancements to their contracts with debtors and, if applicable, subordinate creditors as well as taking certain actions during the course of the proceedings to minimize the risk of being allocated a higher than expected amount of the restructuring costs. Given that the allocation of restructuring costs is decided on a case-by-case basis, upon learning of a filing or a potential filing by a debtor, secured creditors and equipment lessors will be well advised to immediately seek the advice of qualified bankruptcy and insolvency counsel.

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8 *Re Winnipeg Motor Express Inc, supra* note 1.

9 *Ibid.*

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