BANKRUPTCY/INSOLVENCY

Courts deserve credit for success of restructuring phenomenon

By John Jaffey
Toronto

According to Webster's, the word *restructure* — "to change the makeup, organization or pattern of" — was first coined in 1942. It's a relatively new word — even newer in its 1980s application to corporations.

Until then, failing companies were inevitably forced into receivership by creditors, who took their 60 or 40 or 10 cents on the dollar, and didn't think twice about employees who were out of a job, or shareholders who had lost their shirts, or suppliers, or customers, or unsecured creditors or management.

All *these* stakeholders first received official recognition when the federal government passed the *Companies' Creditors Arrangement Act* in 1985. It addressed the possibility that a struggling company still had some value, and that it could be rescued from insolvency through a 30-day grace period of protection from creditors, during which the company could restructure, for example, by selling superfluous assets, reorganizing its finances or finding ways to cut costs.

The analogy to preventive medicine in the health field is a good one. This metaphor can be extended to a dying patient: timing is critical. One of the main problems for companies is that management waits until it is too late to save the patient's life.

Steven Weisz

Take Eaton's. When it filed for court protection under the CCRA in February 1997, its recent year-end statements reported losses of $170 million. Every store needed upgrading, and a full third of the stores were losing money. Yet in its initial restructuring under the CCAA, Eaton's was able to pay all its creditors in full, plus large professional fees.

Unfortunately, the doctor arrived too late. There was *almost* enough value left in the organization to restore it to health. But the malaise at both store and management levels was too far advanced. Even with a second refinancing of $175 million, the new management could not return the company to profitability.

In 1987, a research study about business failure and the turnaround process was undertaken at the University of North Carolina at Chapel Hill. This led to the establishment in 1988 of the Turnaround Management Association (TMA), in which professionals in various fields — lawyers, accountants, lenders, liquidators, auctioneers — could share their knowledge about helping foundering businesses, and make contacts outside their own fields to whom they could refer clients. (See Names in the News, p. 4).

Steven Weisz, President of TMA's Toronto chapter and a partner in the Restructuring & Insolvency Group at Blake, Cassels & Graydon LLP, puts TMA in its proper context for *The Lawyers Weekly* by calling it "a manifestation of what is happening in insolvency law generally." He says, "The Canadian legal system has been very creative in the past 10 years or more to save businesses and their many stakeholders." Weisz illustrates with examples of an interim receiver filing for a restructuring on behalf of the company or obtaining an order permitting refinancing of an insolvent company. These are done through the courts, because "we don't have that concept in any statute, even the CCAA. The courts have developed techniques in case law to allow that kind of refinancing."

In large part, he credits our judges with the success of the restructuring phenomenon. Calling turnaround a "gradual evolution," Weisz says "it has really gained speed, in large part through the development of the

see TURNAROUND p.16

How can you get paid when your client goes bankrupt?

By Brett Harrison

What happens when a solicitor lets a client postpone payment for services because of hard times? Must the solicitor stand in line with other unsecured creditors while the client slips into bankruptcy?

Fortunately, the answer is no, but it is a qualified no. Although solicitors can recover payment, recovery is limited to the extent that they have protected or preserved their client's property through their own efforts, and for only the value of that property.

At common law (which most jurisdictions have codified), solicitors have the right to a charging lien for the "fruits of litigation," including the assets or stream of income the solicitor was instrumental in creating or preserving. Recognized and enforced through the court's equitable jurisdiction, this right allows solicitors to ask courts to exercise their discretion and direct that the property stand as security for the solicitor's fees.

Courts do not create the charging lien; the lien is an inchoate right created by the solicitor's actions and crystallized by the court's order. The lien attaches to the property or fund the moment the property or fund is created, rather than when the court acknowledges it.

But, this inchoate right is not absolute. A charging lien cannot be applied to funds subject to a trust in a third party's favour. Consequently, a deemed or constructive trust that the solicitor's efforts brought about on a client's behalf are not subject to a charging lien.

Moreover, courts only exercise their discretion to recognize the lien when to do so would be just and proper. In *Foley v. David* (1996), 93 O.A.C.114, the Ontario Court of Appeal dismissed a motion for a charging lien because the fund the solicitors sought to charge consisted of court-ordered child and spousal support, the solicitors could recover the fees from other parties, and the individual whose funds the solicitors hoped to charge had in no way benefited from the litigation.

Brett Harrison

When a court is persuaded to recognize the lien, the court may also grant the solicitor priority over secured creditors' claims, even where the secured interest arose before the solicitor rendered services, and the solicitor knew about the pre-existing security. (See *Budinsky v. Breakers East Inc.* (1993), 15 O.R. (3d) 198 (Gen. Div.)).

The bottom line is that when a solicitor's efforts create or preserve a bankrupt client's property, the solicitor may enlist the court's assistance in granting a charging order over the bankrupt's assets related to the services rendered. The solicitor should appear before the bankruptcy court, not the ordinary civil court, to seek relief against the bankrupt's property.

Even if a solicitor does not fulfil the requirements for a charging lien, the nature of the property can affect whether a solicitor's claim is dischargable. In *Lang v. Soyatt* (1988), 68 C.B.R. (N.S.) 201 (Ont. Bkty. Ct.), the court held that cost orders granted in alimony proceedings receive the same protection as alimony and are not discharged in bankruptcy. This reasoning could apply equally to cost orders

see SOLICITOR'S LIEN p.16

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BANKRUPTCY/INSOLVENCY

Avoiding bankruptcy is essential for lawyers

By Stanley Kershman

Almost a third of the people who seek my help when they're in financial difficulties are professionals: doctors, dentists, accountants — and yes, even lawyers.

But for you, financial trouble can go beyond monetary bankruptcy — it can also mean career trouble. Declare bankruptcy, and at the very least, you lose your ability to sign on your clients' trust account. You also face a potential loss of reputation — a serious set-back when your career is built on dispensing legal advice.

And it's deceptively easy to get into financial difficulties that make bankruptcy a potential solution. What happens, for example, if you miss a quarterly income tax payment? Penalties and interest mount, making it increasingly difficult to catch up.

Or what if you're ill or incapacitated for a time? Even with disability insurance, your earnings can drop dramatically while your expenses continue. And if a key client can't pay your bill, even temporarily, what then?

Anything from changes to tax shelter laws, simple overspending, or low legal-aid tariffs can have a devastating effect on your financial picture. Suddenly, your own future is in jeopardy. To maintain your reputation and your clientele, it's essential for you to avoid bankruptcy. Fortunately, the law is on your side in this respect.

Stanley Kershman

First, approach your creditors informally and assess how they respond to a request for interest to be waived or reduced, or bill collection measures stopped, in return for regular, scheduled payments.

In many cases, the chance to recoup their monies while retaining a potentially profitable customer will help your case with your creditor, especially if you have a long-term relationship with them. Even the Canada Customs and Revenue Agency (CCRA) will negotiate with taxpayers to create a payment schedule, holding off potential garnishments of income tax refunds. (Note: CCRA will not reduce the principal amount under this type of an arrangement. If penalties and interest are involved, you would have to file an application to the Fairness Committee.)

If this fails, however, your fallback option is to file a proposal under the *Bankruptcy and Insolvency Act*. A proposal gives you the chance to restructure your financial affairs, emphasizing rehabilitation and repayment of debts rather than liquidation of assets. When you're making a proposal, it's important to decide what's fair to your creditors, as well as what you can financially handle.

Possible solutions include proposing to reduce the principal, reduce or waive the interest, and/or extend the time needed to pay the debt.

Keep in mind that your creditors can either accept or reject your proposal. While they often understand that the law favours the proposal route (and that receiving a reduced payment under a proposal may be better than competing with other creditors for what's left after asset liquidation in a bankruptcy), creditors will also be alert to your earning potential.

Ensure that your proposal is made in good faith and is reasonable under your circumstances. This is particularly important if your debts (not counting your home mortgage) total more than $75,000. This puts you into the category of a commercial, or Division I proposal, meaning that a creditor's refusal of your proposal is an automatic bankruptcy. Below $75,000, you'll file a consumer or Division II proposal, where the implications of creditor refusal are less damaging.

Debt remains constant

Once you file the proposal, interest and penalties stop so that your debt remains constant instead of increasing. If the proposal is accepted, it acts like a debt consolidation loan, allowing you to pay off your creditors as proposed while you carry on in your practice and continue to earn income. In addition, since the proposal is administered through a trustee in bankruptcy (you deposit the funds to the trustee, who in turn pays your creditors as per the terms of your proposal), you no longer have to deal directly with your creditors.

Those are the positives. On the negative side, filing a proposal will be noted on your credit record for three years after its completion. And it's a matter of public record, so it's possible that your clients may find out, shaking their faith in your credibility as a legal advisor.

However, filing and fulfilling a proposal is far preferable to bankruptcy. In that case, you assign your assets to the trustee in bankruptcy, who then liquidates them, in return for debt forgiveness. (Some debts or obligations, however, are not eliminated, including alimony or child support, and a student loan if you've left school within 10 years.)

If it's your first bankruptcy, expect a nine-month process, during which you're required to attend two counselling sessions before the bankruptcy is discharged and you can make a fresh start.

In addition, remember that a creditor can oppose the bankruptcy discharge; in this case, court-supervised mediation may help you solve the problem. Once you are discharged from bankruptcy, your credit record will note the bankruptcy for six years.

Regardless of how you fell into financial difficulties, it is possible to rise above them without damaging your reputation. Early recognition of the potential for problems remains a key part of the solution. While you're taking care of other people's legal and business concerns, make sure you're also paying attention to your own.

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Retaining lien may be of little value

SOLICITOR'S LIEN

–continued from page 15–

granted in obtaining other non-dischargable obligations, such as awards for intentional infliction of bodily harm and debts arising from fraud committed by a fiduciary.

A solicitor may also claim a retaining lien over a client's personal property in the solicitor's possession. A retaining lien attaches to all papers, documents and other personal property that comes into the solicitor's possession with the client's approval.

The few exceptions include a client's will, original court records and a corporate client's books, records and articles of incorporation, unless the solicitor's office is the corporate registered office.

A retaining lien has little value if the client is insolvent; the lien is passive and provides the solicitor with no special rights in a bankruptcy. The solicitor may withhold the property from the client, but generally not from a trustee or receiver, and may not dispose of the property.

Under s. 16(5) of the *Bankruptcy and Insolvency Act,* no person may set up a lien or right of retention on any papers or documents or electronic material, relating to the bankrupt's accounts or trade dealings.

Accordingly, a solicitor's retaining lien on documents is suspended during administration of the estate, and the solicitor must deliver these documents to the trustee. (See *Canadian Triton International Ltd.* (1998), 3 C.B.R. (4th) 231 (Ont. Bktcy. Ct.)).

Rule 68(4) of the *Orderly Payment of Debts Regulations* provides that documents subject to a solicitor's lien must be returned to the solicitor once administration of the estate is complete. However, by that time the documents would likely be of little use to enforce payment of fees.

'The solicitor may withhold the property from the client, but generally not from a trustee or receiver.'

Because the solicitor's right to a retaining lien is only as great as the client's right, the lien is also not effective against third parties with a right to seize the client's property, including receivers.

Although Rule 68(4) does not apply to receivers or trustees under proposals, courts have held that that the right to obtain books and documents in the solicitor's possession should be granted to these individuals for only a limited time, and the solicitor's lien should be maintained.

Although solicitors are compelled to provide these documents, the good news is the courts have held that solicitors may be entitled to reimbursement for the cost of preparing a list of files in their possession and certain necessary disbursements, to the extent the trustee or receiver requests these services.

Courts have also explicitly stated that time spent reviewing files to determine whether they contain documents belonging to the debtor will not be reimbursed (See *Bank of Nova Scotia v. Imperial Developments* (1987), 66 C.B.R. (N.S.) 13 (Man. Q.B.)).

Since retaining liens have little value in insolvency, the best advice for those who do not fulfil the requirements of a charging lien is to require the client to execute a security agreement, subject to relevant fraudulent conveyances legislation.

Otherwise, a solicitor could end up with nothing but a few cents on the dollar and a file full of useless documents after a client declares bankruptcy.

Brett Harrison is an associate at McMillan Binch LLP in the litigation and corporate restructuring groups.

Four-step process

TURNAROUND

–continued from page 15–

commercial list in Toronto." Singling out Justices Lloyd Houlden, James Farley, John Ground and Edward Saunders as judges who are willing to be flexible and creative, Weisz says, "The courts are very cognizant of the various stakeholders and have the ability to deal with very complex matters in short order. I think we owe a lot to the very dedicated judges who are involved."

In a story in *The Lawyers Weekly* in March 2000, Weisz wrote: "The court-driven process assists in dealing with disparate interests and keeps all stakeholders focused on maintaining overall value of the assets of the company as opposed to a situation in which all stakeholders would scatter and dismantle the debtor's assets to protect their own self-interest."

There are four phases of a turnaround, which involve the help of outside professionals. (Obviously, the stakeholders will be reluctant to entrust the restructuring to those who allowed the company to fail in the first place.)

The first step is stabilization: This involves an assessment of the troubled company and a focused effort to stop the bleeding and increase cash flow.

The second is analysis: A thorough business plan must be created to focus on the strategic position of the company and its core competencies.

Third is repositioning: The interim managers must create a value recovery plan. That involves raising debt financing and changing the company's management structure.

The final step is strengthening the phoenix that has risen from the ashes: By combining new financial structures with new organization, the company can move forward and grow.