June 1, 2021

A Generalized Duty of Good Faith Applied to Disclaimer Under the *CCAA*

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Case Commented On: *Laurentian University v Sudbury University*, 2021 ONSC 3392 (CanLII)

In this case, the court considered the new generalized duty of good faith in relation to setting aside a disclaimer under the *Companies' Creditors Arrangement Act*, RSC 1985, c C-36 (*CCAA*). When Laurentian University (LU), sought to disclaim agreements with the University of Sudbury (Sudbury) as part of its restructuring, Sudbury brought this motion to set the disclaimer aside, arguing that LU was using the *CCAA* restructuring process for a collateral or illegitimate purpose, namely to destroy a competitor (at paras 22—24). Sudbury argued that LU's attempt to disclaim these agreements was a violation of its duty to act in good faith as per s 18.6. Concurrent to this motion, Thornloe University (Thornloe) also brought a motion against LU, dealing with the same issue – to set aside a disclaimer – using similar good faith arguments (*Laurentian University of Sudbury*, 2021 ONSC 3272 (CanLII) [*Laurentian University*]). Each motion was dismissed.

Section 18.6 (and the identical provision in the *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 s 4.2), came into force on November 1, 2019 (pursuant to Bill C-97), and provides that, "[a]ny interested person in any proceedings under [each] Act shall act in good faith with respect to either proceeding"(*CCAA* at s 18.6(1)). The amendments also give the courts the power, upon the application of any interested person, to make any order they consider appropriate in the circumstances if an interested person fails to act in good faith (*CCAA* at s 18.6(2)).

The duty in s 18.6 is freestanding and abstract; as in, it is not anchored to parties or to their obligations. Without identifying the parties to whom the obligation attaches, and the underlying substantive obligations, there is no context to this duty. How, then, will parties be able to determine the content of the duty, or the standards of behaviour required in specific circumstances? The impact of this duty on insolvency proceedings will not be seen for several more years, but in general, freestanding statutory duties usually raise concerns about *ad hoc* judicial moralism, they lengthen proceedings, increase costs, and create unpredictability. For now, cases such as these are setting the groundwork for how s 18.6 will be interpreted and applied in relation to specific provisions in the *CCAA*.

Facts

LU had been experiencing financial problems for years, and eventually sought protection under the *CCAA* on February 1, 2021. An initial stay of proceedings was granted on that date and extended most recently to August 31, 2021 (*CCAA* at ss 11.02(1) & (2)).

One component of LU's restructuring involved terminating its relationship with three Federated Universities: Sudbury, Thornloe, and Huntington University (Huntington) (together the Federated Universities). On April 1, 2021, LU issued a Notice of Disclaimer (the Disclaimer) pursuant to s 32 of the *CCAA* to disclaim certain contracts between LU and the Federated Universities. Huntington and LU came to an agreement on dissolving the partnership, but Thornloe and Sudbury commenced motions to set aside the Disclaimer. Each motion was dismissed; these are the reasons for the Sudbury motion; the reasons for Thornloe's motion are dealt with in *Laurentian University*.

During the restructuring, LU received court approval for debtor in possession (DIP) funding of $25M, then sought an additional $12M. Its DIP lender agreed to provide additional funding of $10M but used the Disclaimer of the agreements with the Federated Universities as a pre-condition.

Each of Thornloe, Huntington and Sudbury is a separate legal entity with its own Board of Governors, but programs for all the Federated Universities are offered through LU and receive credit towards a degree that is granted by LU (at para 8). Pursuant to the Federation Agreements LU has with each of the three universities, which are substantially similar, each of the Federated Universities is required to suspend its degree-conferring powers in favour of LU. LU must distribute to each Federated University a portion of the revenue it received for each student, and LU must reserve land on its campus for the Federated Universities.

Under the Financial Distribution Notices, LU would transfer to each of the Federated Universities a portion of the revenue it receives from the provincial government. It could also assess a 15% administrative service fee on grant and tuition revenue received, then pass on the net amount to the Federated Universities (at para 13).

In 2020, LU transferred $7.7M to the Federated Universities, net of the service fee, but LU required this amount as part of its restructuring plan, meaning that LU sought to have the former students of the Federated Universities as part of its student body in order to cease transferring that revenue to the Federated Universities (at para 14).

Law & Arguments

Under s 32(1) of the *CCAA*, the debtor company may disclaim any agreement to which the company is party. Section 32(2) allows a court to prohibit the disclaimer, and its decision must consider whether the monitor approved the proposed disclaimer; whether the disclaimer would enhance the prospects of a viable compromise; and whether the disclaimer would likely cause significant financial hardship to a party to the agreement.

Section 32 does not impose an express duty of good faith on the parties, but the court considered the generalized duty of good faith in s 18.6. It also considered whether relief is reasonably necessary for continued operations of the debtor company under s 11.001.

Sudbury argued that LU's attempt to disclaim these agreements was a violation of its duty to act in good faith as per s 18.6. It maintained that LU had not attempted to find alternate solutions, such as renegotiating its service fee (at para 26). It also argued that the Disclaimer would impact

LU's obligations to the francophone community as it would disproportionately impact the French programs and courses (at paras 48—53).

Decision

The court found that LU had sought to Disclaim the Federation Agreements to put "an end to an unsustainable financial model" (at para 29), which is not an improper or illegitimate purpose. It found that the first two statutory requirements for a disclaimer were met: that the Monitor had approved the Disclaimer (at paras 45—46) and that disallowing the Disclaimer would seriously diminish the prospects of a viable plan, as without it, LU would not have the DIP funding necessary to file a proposal (at para 30). It also found that LU had attempted negotiations with the Federated Universities and that LU did not have a legal duty to act in the best interests of the Federation, but it did have a duty to its creditors (at para 30). With regard to the third statutory requirement, financial hardship to Sudbury, the court found that Sudbury would suffer financial hardship but that it had not provided evidence to show that hardship would meet the threshold of "significant financial consequence" (at para 39).

Finally, the court determined that post-disclaimer, Sudbury would be free to establish itself as a francophone university without the constraints of the Federation Agreements.

Analysis and Commentary on the Application of Section 18.6

There are several provisions in insolvency legislation that require a duty of good faith, but these provisions are contextual – they are attached to parties and responsibilities. For example, a debtor who applies to extend the initial stay of proceedings must show that it has acted and is acting in good faith (*CCAA* at s 11.02). That particular context – the debtor applying for an extension to the stay in order to continue working toward a restructuring – requires the debtor to show that it has been doing its best to pursue a plan, typically evidenced by the debtor cooperating and being transparent with the monitor, negotiating for DIP financing, and reducing its overall costs (see, for example, *Re Worldspan Marine Inc*, 2011 BCSC 1758 (CanLII)).

A generalized duty of good faith is different. Without identifying the parties or the underlying responsibilities, how does a freestanding duty acquire the context it needs to provide a framework in which courts and parties could determine how to discharge it? After all, a generalized duty is not substantive; it simply governs parties' behaviour as they perform their substantive tasks. For that reason, I have been doubtful as to the efficacy of this duty (see J Girgis, "A Generalized Duty of Good Faith in Insolvency Proceedings: Effective or Meaningless?" (2020) 64 Can Bus LJ 98).

Outside this generalized duty, and apart from the express good faith duties attached to particular provisions in insolvency legislation, there is, of course, the "well established requirement" that parties must act in good faith in insolvency proceedings (*9354-9186 Québec inc v Callidus Capital Corp*, 2020 SCC 10 (CanLII) at para 50). Janis Sarra has written that these requirements include parties acting "candidly, honestly, forthrightly and reasonably in their dealings with one another and the court" ("La bonne foi est une considération de base – Requiring Nothing Less than Good Faith in Insolvency Law Proceedings" in Janis Sarra & Barbara Romaine, eds, *Annual Review of*

Insolvency Law, (Toronto: Thomson Reuters Canada, 2014). These requirements would be expected in any proceedings, not just insolvency. So this leaves us with the question of whether the generalized duty is simply the codification of that requirement, as the Supreme Court said in *Callidus* (at para 50), or whether these provisions open the door for a more expansive duty?

A freestanding duty is worrisome for all the usual reasons – it raises concerns about *ad hoc* judicial moralism, it generates litigation and increases its costs, and the cases often have little precedential value as there is no limit on the types of proceedings that are challenged, and the decisions tend to be fact-specific. The reality, however, is it may not alter much in *CCAA* proceedings, at least with regard to the debtor company. Since the statute contains built-in protections that allow the court to monitor the debtor's behaviour throughout the course of the restructuring, the court can easily ensure the debtor is not acting in bad faith, without having to resort to s 18.6. One example is s 11.02, which, as discussed above, allows the initial stay to be extended as long as the debtor has been acting and is acting in good faith. Another example is the monitor, an independent and impartial expert who oversees the proceedings and reports to the court on the debtor's behaviour (*Callidus* at para 52). Under s 11 of the *CCAA*, the court has inherent jurisdiction to impose relief when it is not specifically addressed in the statute. The court can also use the common law illegitimate or improper purpose test.

In this case, the court had to consider whether LU had acted with an illegitimate or improper purpose by pursuing disclaimers. The "improper" or "illegitimate purpose" test is not codified, but courts use it to determine whether parties have acted in good faith by considering both what a party should be doing in a particular context and the goals underlying the legislation, which would, in this case, be to restructure or save businesses. Sudbury argued that LU was using the *CCAA* restructuring process to effectively destroy a competitor, which would be an abuse of process (at para 22). The concurrent decision, *Laurentian University*, did not mention "improper purpose" *per se*, but Thorneloe did argue that Laurentian's attempt to terminate their relationship, knowing the disclaimer would result in Thornloe's insolvency, was bad faith.

Improper purpose has been found to mean acting for "a purpose not intended or contemplated by the legislation" (*Re Blackburn Developments Ltd*, 2011 BCSC 1671 (CanLII) at para 31) or "any purpose collateral to the purpose for which the bankruptcy and insolvency legislation was enacted by Parliament" (*Promax Energy Inc v Lorne H Reed & Associates Ltd*, 2002 ABCA 239 (CanLII) at para 2). In *3004876 Nova Scotia Ltd v Laserworks Computer Services Inc*, 1998 NSCA 42 (CanLII) the Court of Appeal maintained that motive is relevant in the analysis for improper purpose and said that "[u]sing bankruptcy to cause injury, thereby eliminating the debtor as an entity capable of competing in the marketplace" is voting to bring about "substantial injustice" and is not permitted (at para 52). Similarly, in *Dimples Diapers Inc v Paperboard Industries Corp*, 1992 CarswellOnt 192, 15 CBR (3d) 204 (Ont Ct J (Gen Div)) which dealt with the filing of a petition for a receiving order (now a "bankruptcy order") under the *BIA*, the court maintained that the petition must not be filed for a collateral purpose, which would include removing a business competitor (at para 34).

In this case, the court found that LU had not acted for an improper purpose by disclaiming the contract but had simply been attempting to cease its unsustainable financial model (at para 30), which falls squarely within the purpose of the legislation. In the concurrent decision, *Laurentian*

University, the court looked at the fact that the monitor had not suggested the debtor was acting in bad faith, and also, that the court had not found bad faith when it was extending the stay of proceedings.

Cases such as this one and *Laurentian University* are setting the groundwork for how s 18.6 will be applied. As to a broader application of these good faith provisions, and whether the freestanding duty of good faith alters *CCAA* proceedings for other parties, such as creditors, is an issue for another post. For now, I will say that it raises a number of questions.

This post may be cited as: Jassmine Girgis, "A Generalized Duty of Good Faith Applied to Disclaimer Under the *CCAA*" (June 1, 2021), online: ABlawg, http://ablawg.ca/wp-content/uploads/2021/06/Blog_JG_Good_Faith_Laurentian_University.pdf