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Classifying Creditors under the Companies' Creditors Arrangement Act

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Cases Considered:

Kerr Interior Systems Ltd. (Re), 2008 ABQB 286

In an application for an order to sanction a Plan of Arrangement (Plan), the Alberta Court of Queen's Bench refused to allow the two protesting creditors to form their own class for the purpose of voting on the Plan in *Kerr Interior Systems Ltd. (Re)*. For the purpose of this post, I will lay out the facts then focus on the principles underlying the classification of creditors under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 (*CCAA*). Pursuant to section 4 *CCAA*, different classes of unsecured creditors can be created, such that each class would have a separate vote on whether to approve a Plan. This case is one of the most recent to deal with the technical and difficult issue regarding the classification of creditors and Madam Justice M.B. Bielby provides a thorough discussion of the principles that need to be considered before a court will sanction a plan of arrangement.

Kerr Systems Ltd. (Kerr) and Composite Building Systems Inc. (Composite) are each a fully-owned subsidiary of 1005559 Alberta Ltd. (105) and together are the Debtors and Applicants. The issue came before Bielby J. on April 4, 2008 when the Debtors applied to the Court for a sanction of a Plan under the *CCCA* and two of the creditors were opposed: Kenrock Building Materials Co. Ltd. (Kenroc) and Winroc, a Division of Superior Plus LP (Winroc).

Each Debtor carries on business separately from the other; some of the debts owed by one Debtor are cross-guaranteed by the other. When the Debtors encountered financial difficulty, they attempted to compromise their debt obligations and satisfy their outstanding contracts with a view to remaining in business. To that end, a stay order was granted on November 7, 2007, declaring that the *CCAA* applied to the Debtors, prohibiting any proceeding from being commenced against them and suspending or staying any proceedings in respect of the Debtors that were already underway.

The stay order was served on Kenroc on November 9, 2007. On November 15, 2007, without seeking or obtaining leave of the Court, Kenroc registered a lien with the Land Titles Registry in Saskatchewan, against title to a building owned by 101051911 Saskatchewan Ltd. (101) for $103,355.23. The Debtors had been hired by 101 to be contractors on a building construction project but otherwise, had no relationship to 105 (*Kerr Interior Systems Ltd.* at para. 12). Winroc

had supplied materials to Kerr between June 2007 and November 2007, for use on the renovations on that building and on November 6, 2007, Winroc filed a lien against title of the building in Saskatchewan for $46,425.26. The two liens caused 101 financing difficulty so it had the liens discharged by paying $150,000 into the Saskatchewan Court of Queen's Bench on January 18, 2008. Those funds remain in the Court.

The Plan put forward to Bielby J. for approval created a single class of unsecured creditors, which included Kenroc and Winroc. The Plan proposed to pay each creditor 52% of the debt owed to it on November 7, 2007. The Plan also saw the $150,000 held by the Saskatchewan Court paid to Kerr and the security standing in place of the builders' liens discharged. Of the total creditors, 92% approved the Plan. Kenroc and Winroc opposed the Debtors' application seeking an order sanctioning the Plan and maintained they should have their own class for two main reasons. First, they sought to be treated as secured creditors, which would make their claim separate and apart from the main class of unsecured creditors. In the alternative, they argued that if they were to be characterized as unsecured creditors, they had claims different in nature than those of the other unsecured creditors. Bielby J. considered each of their arguments in detail and concluded that Kenroc and Winroc were unsecured creditors and would be included in the class of unsecured creditors for the purpose of voting.

The reasons put forward by Kenroc and Winroc in support of their arguments for a separate class are extensive and due to space limitations, the discussion below deals with the principles that must be considered when a court is deciding whether a separate class of creditors should be allowed. It is sufficient to say that they argued for a separate class of unsecured creditors on the basis that their lien claims were different than the rest of the unsecured creditors, an argument rejected by Justice Bielby. In refusing to find in favour of the two creditors, Bielby J. made her decision by considering that "creditor classification should be crafted in accordance with the underlying *CCAA* purpose to facilitate reorganization of the debtor" (at para 96).

Persuading a court to create a separate class of unsecured creditors is not an easy task, nor should it be. Since the purpose behind the *CCAA* is to help insolvent debtor corporations avoid bankruptcy by negotiating plans of arrangement with their creditors, the vote on a plan stands a better chance of success if excessive fragmentation of creditor classes is avoided. The importance of the *CCAA* cannot be overstated, as a successful corporate restructuring means the disastrous social and economic impact of a bankruptcy is avoided - the corporation continues operating, shareholders continue to enjoy returns on their investments, employees continue working, creditors can anticipate being paid more than they would in the event of a bankruptcy, and society benefits from the continued services provided by the corporation.

The classification of creditors in the context of the goals of the *CCAA* can be a difficult task. While the factual issues must be considered, the court must also make its decision with a view to facilitating a restructuring process, a process which can be hampered by the excessive fragmentation of creditors. An excellent articulation of the conflict was adopted in *Norcen Energy Resources Ltd. v. Oakwood Petroleums Ltd.* (1988), 72 C.B.R. (N.S.) 20 at paras. 43-44 (*Norcen Energy*):

> 43 From the foregoing one can perceive at least two potentially conflicting approaches to the issue of classification. On the one hand there is the concept that members of a class ought to have the same "interest" in the company, ought to be only creditors entitled to look to the same "source" or "fund" for payment, and ought to encompass all of the creditors who do have such an identity of legal rights. *On the other hand, there is recognition that the legislative intent is to facilitate reorganization, that excessive fragmentation of classes may be counter-productive and that some degree of difference between claims should not preclude creditors being put in the same class.*
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> 44 *It is fundamental to any imposed plan or reorganization that strict legal rights are going to be altered and that such alteration may be imposed against the will of at least some creditors…*

(See also *ATB Financial v. Metcalfe Mansfield Alternative Investments II Corp.*, 2008 CarswellOnt. 2652 (Ont. SCJ [Commercial List]).

Several principles must be noted when the court is determining the proper classification of creditors. Creditors must be classified according to their "commonality of interest", meaning their "rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest" (*Sovereign Life Assurance Co. v. Dodd*, [1892] 2 Q.B. 573 (Eng. C.A.)). However, the classification is not to be determined by creditors' relationships to each other, but rather, to the debtor company (*Canadian Airlines Corp., Re* (2000), 19 C.B.R. (4th) 12 (Alta. Q.B.)), an approach that was expressly adopted by the Ontario Court of Appeal in *Stelco Inc., Re* ((2005), 2005 CarswellOnt 6818 (Ont. C.A.) paras. 30, 34 (*Stelco*)). In Norcen Energy, supra, the court went so far as to determine that using the "identity of interest" as a starting point "necessarily results in a 'multiplicity of discrete classes' which would make any reorganization difficult, if not impossible, to achieve" (at para. 46).

In this case, of the 34 creditors with potential lien rights, 28, holding over 85% of the debt, voted in favour of the Plan (para. 104); Kenroc and Winroc held 3% of the debt. Kenroc and Winroc were the only creditors who appeared in opposition to the application for court sanction of the Plan, and by their own admission, did not necessarily want the Plan defeated but rather, wanted to enhance their bargaining position with the Debtors (para. 109). In that regard, Bielby J.'s decision was very much in accordance with avoiding what the Ontario Court of Appeal has labelled "a tyranny of the minority" (*Stelco*, supra at para. 28). Accordingly, Bielby J. determined that given the "overwhelming creditor support for the Plan," it was fair and reasonable and it would, in fact, not be fair and reasonable to allow the two creditors to defeat it (at para. 108).