The New Duty of Good Faith in Canadian Insolvency Proceedings

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Written by Raj Sahni

Canada's two main insolvency and restructuring statutes, the *Bankruptcy and Insolvency Act* (BIA) and the *Companies' Creditors Arrangement Act* (CCAA) were recently amended to include a new duty of good faith on the part of all "interested persons" involved in an insolvency proceeding. The amendments do not define "good faith" or "interested persons". Although requiring all participants in an insolvency proceeding to act in good faith may be a laudable objective, the statutory amendments are problematic. The amendments do not define what the duty of good faith actually entails while at the same time allow any interested person to complain to the court that the duty has been breached by another interested person. If the court finds that this undefined duty of good faith has been breached, the court is given very broad powers to make any order it considers appropriate in the circumstances. In addition, not defining "interested persons" could be problematic. To date, Canadian courts have been generous in allowing those claiming an "interest" in proceedings, including "social stakeholders"—a constituency with no economic interest in the debtor's estate—to participate in insolvency and restructuring proceedings.[1] This article discusses the new duty of good faith under the BIA and CCAA and considers how the duty might be interpreted, using the U.S. principle of equitable subordination for comparison.

The new duty of good faith has been enacted under sections 4.2 of the BIA and 18.6 of the CCAA, as follows:

Good faith

> 1. Any interested person in any proceedings under this Act shall act in good faith with respect to those proceedings

Good faith—powers of court

> 2. If the court is satisfied that an interested person fails to act in good faith, on application by any interested person, the court may make any order that it considers appropriate in the circumstances.

A duty of good faith in insolvency and restructuring proceedings is not a new concept under Canadian law. Prior to the above-noted amendments, the statutes already mandated a good faith duty for trustees in bankruptcy, receivers and monitors, and the debtor company.[2] Moreover, the Supreme Court of Canada has previously recognized good faith as a “baseline consideration”[3] in restructuring proceedings and as a “general organizing principle of the common law of contract”.[4] However, an express statutory duty on the part of all participants (including creditors) in an insolvency proceeding is new. In circumstances where restructuring and insolvency proceedings in Canada are already supervised by a court and court-appointed officers (monitors, receivers and trustees) to ensure that the proceedings are conducted in accordance with the law and that restructuring plans are fair and reasonable, it is not clear what benefit is derived from the addition of an undefined duty of good faith on the part of all interested parties to an insolvency proceeding.

A creditor in an insolvency proceeding can be expected to act in its economic self-interest to maximize returns in accordance with its legal rights and priorities, often in competition with other creditors and stakeholders. Combining

an undefined statutory duty with a very broad power for a court to “make any order that it considers appropriate in the circumstances” may lead to an increase in disputes between creditors, the debtor(s), and other participants in insolvency proceedings, since an application impugning an interested person’s good faith can be brought by any other interested person in the proceedings. Insolvency is often a zero-sum game, where one participant’s gain is another participant’s loss. Applications alleging bad faith could conceivably be launched out of self-interest by participants clamoring for priority or seeking to discredit the claims of other creditors to maximize their own recoveries or even by “social creditors” who do not have an economic interest in proceedings. This may in turn lead to increased uncertainty and costs to the detriment of all participants in an insolvency proceeding as a participant’s intent and good faith (or lack thereof) becomes an issue to be considered by the courts in addition to the legal priorities of its claims.

As there is not yet (at the time of writing this article) any reported jurisprudence interpreting the new good faith requirement under the BIA and CCAA, it is helpful to review some examples where courts have considered creditors’ conduct in insolvency and restructuring proceedings in Canada. Such a review will help provide some guidance as to how the duty of good faith might be interpreted and applied. Two relatively recent cases emanating from courts in the Canadian province of Quebec may be informative. In addition to the common law and statute based legal system used in the rest of Canada, Quebec is the only province with a civil code, based on the French Napoleonic Code. The duty to act in good faith in court supervised proceedings has long been codified under the Quebec Civil law.[5] Therefore, while not previously a formal requirement under Canada’s federal insolvency statutes (BIA and CCAA), whether a participant in an insolvency proceeding is acting in good faith is often considered (albeit sometimes informally) in insolvency cases before Quebec courts.

In its March 16, 2018, decision in the *Bluberi Gaming Technologies Inc.* CCAA case,[6] the Quebec Superior Court considered whether the secured creditor (Callidus Capital Corporation (Callidus)) of the CCAA debtors should be

permitted to vote in favour of its own plan of arrangement in respect of the CCAA debtors in circumstances where it was alleged that the secured creditor's plan was being advanced primarily to avoid and obtain releases from claims being pursued against Callidus by the CCAA debtors. While the Court recognized prior case law that confirmed creditors are entitled to vote their claims in "their own economic interests as long as their actions are not unlawful or do not result in substantial injustice",[7] the Court held that Callidus should not be permitted to advance and vote in favour of its proposed plan of arrangement in such circumstances:

> It is one thing to let the creditors vote on a plan submitted by a secured creditor, it is another to allow this secured creditor to vote on its own plan in order to exert control over the vote for the sole purpose of obtaining releases. Under the present circumstances, this approach is both unfair and unreasonable. [...] Callidus' behavior is contrary to the "requirements of appropriateness, good faith, and due diligence [that] are baseline considerations that a court should always bear in mind when exercising CCAA authority." [...] In short, the Court finds that Callidus intends to use its vote for an improper purpose and that it should not be allowed to do so.[8]

The *Bluberi* decision was reversed on appeal and the Quebec Court of Appeal noted that Callidus was not acting improperly in seeking a release through the plan of arrangement proposed by it and that "voting rights should not be excluded on supposed 'equitable grounds'."[9] That decision was further appealed to the Supreme Court of Canada, which overturned the Quebec Court of Appeal's decision. The Supreme Court of Canada's reasons have not yet been released as of the date of this article, so it is unknown whether the Supreme Court of Canada considered the "good faith" issue.

The Quebec Court of Appeal's stance in *Bluberi*, that creditors are entitled to act in their own self-interest and their voting rights of creditors should not be interfered with on equitable grounds, is in interesting contrast to its earlier stance in the *Uniforêt* case.[10] In *Uniforêt* the Quebec Court of Appeal upheld a Quebec Superior Court decision

denying a debentureholder group's motion to vote in a separate class on the basis that it was found to be acting in a self-interested manner:

> [The] Petitioners' motives and good faith are seriously in issue. […] [The] Petitioners persist in obstructing the plan in order to achieve their own ends, without regard to the results on the Company, the creditors, and community as a whole. They obviously have no interest in facilitating the reorganization of the Company but seek to maximize their return at all costs, even if it means liquidation, in which case they too will lose.[11]

The inconsistency between the appellate court decisions in *Bluberi* and *Uniforêt* provide little clarity on how the good faith standard will be interpreted and applied by Canadian courts going forward. Clearly the Quebec Court of Appeal took the motives of the creditors seeking to exercise their voting rights into account in both cases. Still, on the one hand the court held that self-interested conduct by a creditor (proposing a plan of arrangement to seek releases only for itself from claims asserted by the CCAA debtors) did not constitute bad faith sufficient to interfere with voting rights, while on the other hand the court held that other self-interested conduct by a creditor (threatening to vote down a plan of arrangement to negotiate a better return for debentureholders) did constitute bad faith. Perhaps the Supreme Court of Canada's consideration of *Bluberi* will help shed some light on the "good faith" standard to be imposed upon and expected of creditors and other participants in insolvency and restructuring proceedings going forward.

In addition to the question of what the duty of "good faith" actually entails and what type of conduct may fall short of meeting that duty, an equally important question is what remedy a Canadian court ought to employ against an interested party who has found to have acted in bad faith in an insolvency or restructuring. As noted above, upon finding that the duty has been breached, the court has the power to make any order that it considers appropriate in the circumstances. Such broad remedial powers may be cause for worry, particularly in circumstances where the

"offence" is undefined and there is little prior Canadian jurisprudence to rely upon. While Canadian courts have expressly stated that the U.S. doctrine of equitable subordination is not applicable in Canada,[12] a brief review of the doctrine may be helpful in providing examples of when a Canadian court ought to interfere with a creditors legal rights and what the appropriate remedy may be.

The U.S. doctrine of equitable subordination was expressed by the United States Supreme Court in its 1939 decisions in *Pepper v Litton* and *Taylor v Standard Gas Electric*.[13] Grounded in the jurisdiction of bankruptcy courts as courts of equity,[14] the Supreme Court applied the doctrine to subordinate the claims of creditors who had, by their conduct, wrongfully advanced their interests to the detriment of their fellow creditors.

The doctrine has been codified in section 510(c) of the *Bankruptcy Code*, which provides that:

> after notice and a hearing, the court may—

1. under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
2. order that any lien securing such a subordinated claim be transferred to the estate.[15]

Taken together, where a claimant is "guilty of misconduct that injures other creditors or confers an unfair advantage" equitable subordination may be invoked to reorder statutory priorities, for example, reducing secured claims to unsecured claims or even equity claims.[16] Courts have noted that equitable subordination is "an extraordinary remedy to be employed […] sparingly".[17] The categories of inequitable conduct for which the doctrine is typically invoked include:

1. fraud, illegality, breach of fiduciary duties;
2. undercapitalization; and
3. claimant's use of the debtor as a mere instrumentality or alter ego.[18]

In the case of alleged inequitable behaviour by an arms-length creditor, courts have been reticent to employ the doctrine.[19] In some cases, courts have required "wrongful conduct that rises to the level of 'gross and egregious,' 'tantamount to fraud, misrepresentation, overreaching or spoliation,' or 'involving moral turpitude' before equitable subordinating an outside creditor's claim."[20] If however, the claimant is a fiduciary or insider of the debtor, a less stringent standard applies. The moving party must only establish "some unfair conduct, and a degree of culpability, on the part of the insider."[21]

While Canadian courts have noted that the doctrine of equitable subordination is not applicable in Canada, the many decades of U.S. jurisprudence and the conclusions of the U.S. courts that it is an extraordinary equitable remedy to be employed sparingly in cases of wrongful or egregious conduct may provide helpful guidance as to how the new statutory duty of good faith and the broad powers of the Canadian courts should be interpreted and applied.

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