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Court Approves Restructuring Plan for Failed Asset-Backed Commercial Paper

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On June 5 2008 the Ontario Superior Court of Justice approved a plan concerning failed asset-backed commercial paper (ABCP). The restructuring called for in the plan can therefore proceed immediately, subject to any appeals from the court approval. This update is a brief survey of the key developments in the efforts to rescue the affected Canadian market for ABCP, which broke down in August 2007.

Breakdown of Market and the Montreal Accord

Following the sub-prime mortgage crisis in the United States, the Canadian market for non-bank-sponsored ABCP, the underlying assets of which included or were feared to include sub-prime mortgages, fell into turmoil in early August 2007. The ABCP market soon broke down when the issuers of ABCP were unable to find buyers for maturing notes and banks that had agreed to provide the issuers emergency liquidity declined to provide the funds necessary to pay off the maturing notes (apparently on the grounds that the conditions for the provision of liquidity had not been met).

In response, a group of institutions consisting of major investors in ABCP, issuers of ABCP and liquidity provider banks convened a meeting in Montreal with a view to finding a solution to the crisis. This meeting resulted in the Montreal Accord, under which the parties agreed, among other things, that: (i) all affected ABCP (worth approximately C\$32 billion) would be converted to long-term floating notes; and (ii) in order to facilitate this conversion, the parties would 'stand still' for 60 days in respect of any action relating to ABCP. The standstill agreement, which has been extended many times since then, effectively froze any trading of ABCP.

It is estimated that institutional investors hold 99% of the total value of the money invested in the frozen ABCP, but these investors make up a small group (fewer than 200 in number) compared to retail investors in the affected ABCP (around 2,000).

Restructuring Plan

A committee of large investors which formed to implement the Montreal Accord determined that the restructuring of ABCP would take the form of a plan of compromise and arrangement under the Companies' Creditors Arrangement Act, one of the Canadian statutes dealing with insolvency. In March 2008 a bankruptcy court judge (Justice Colin Campbell) agreed to oversee

the restructuring. Under the plan, ABCP, which was originally meant to be a short-term investment with liquidity resembling that of cash, will be swapped for new, longer-term notes. These new notes are designed ultimately (in approximately eight years) to give back to the holders of ABCP all of the money they invested in ABCP. However, the notes are expected to trade at a substantial discount initially and it could take many years for an investor to recover its money in full.

Under the Companies' Creditors Arrangement Act, in order for a plan to become effective, it must be approved by a majority of noteholders representing two-thirds in value of all affected ABCP and by the court.

While the plan was being worked out, retail ABCP investors, which held an overwhelming majority of votes on the plan, began to voice their objection that the plan, which was being created without their input, was unfair to their interests. These investors ultimately prevailed and in the resulting arrangement, if the plan becomes effective, noteholders holding less than C\$1 million in the affected ABCP (estimated to be 1,800 in number) will recover the full value of their investments.

Dispute over Releases and Noteholders' Vote

A particularly controversial part of the plan turned out to be a set of comprehensive releases from liability of the institutions that created and sold the failed ABCP. Drafted in very broad terms, the releases would effectively preclude noteholders from bringing any legal action, including claims for fraud, against these institutions. Retail investors with more than C\$1 million invested in the affected ABCP (to whom the arrangement for recovery of 100 cents on the dollar does not apply) took strong exception to these releases, as they believed that their right to sue the financial institutions that created and sold the ABCP (eg, the issuers, investment dealers and banks) was more valuable than that which they would be entitled to under the plan.

Some of these investors brought a last-minute motion before the bankruptcy court seeking to postpone the vote on the plan, which was scheduled to take place on April 25 2008. They also sought from the court a determination that the releases were overly broad, confiscatory of their rights and therefore illegal, and an order that, for the purposes of the vote, corporate and individual noteholders which objected to the releases form a separate class whose approval would be necessary for the plan to be put into effect. This motion failed. The court held that the vote should go ahead as planned, since postponing the vote would signal the failure of the plan, which would have extremely serious consequences. The concerns regarding the releases could and should be dealt with at the final hearing on the general fairness of the plan.

As a result, the vote took place as scheduled and almost 96% of the voters, representing C\$28.8 billion of the money invested in the failed ABCP, voted to approve the plan.

Amendment to Releases

The fairness hearing took place on May 12 and May 13 2008. A few days after the hearing the court released what may be called an interim decision on the plan, which made clear that it would not approve the plan unless the scope of the release were reduced to exclude fraud. It stated that it was:

“not satisfied that the release proposed as part of the plan, which is broad enough to encompass release from fraud, is in the circumstances of this case at this time properly authorized by the [Companies’ Creditors Arrangement Act], or is necessarily fair and reasonable.”

At the same time, the court held that in its view, the spirit of the Companies’ Creditors Arrangement Act would permit the release of negligence claims in the circumstances before it. In the result, the court asked that the parties find a way to deal with fraud claims, effectively leaving the decision on the plan up to the financial institutions involved.

The ensuing negotiations among the parties resulted in a narrow reduction in the scope of the release: under the amended release, investment dealers that sold the affected ABCP (but no other financial institutions) may be sued for fraudulent misrepresentation (ie, false representation knowingly and directly made to noteholders).

Court Approval of Plan

The court approved the plan in a decision released on June 5 2008, finding that the amended release was fair and reasonable. In doing so, it noted that the plan represents a highly complex and unique situation that could not succeed without the compromises it involved. In its view, a compelling case for comprehensive releases had been made and the narrow scope of the fraud 'carve-out' was justified by the need to avoid a “potential cascade of litigation” (resulting from a defendant first sued in turn claiming against another party, which process may occur successively). Noting that “[n]o plan of this size and complexity could be expected to satisfy all affected by it,” the court concluded that the plan represents a reasonable balance between benefit to all noteholders and enhanced recovery for those who can make out specific claims in fraud.

As the court noted in its reasons for the decision, some of the parties have expressed their intention to appeal and it seems likely that if such an appeal is heard, it will be on an expedited basis.

Unless an appeal is brought and the appellate court overturns the decision to approve the plan, the market crisis brought on by the ABCP meltdown would seem to have been resolved in a way that satisfies a majority of the noteholders. The case does, however, raise certain interesting legal issues, including the issue of the limits of the court’s jurisdiction in approving compromises reached by the parties, particularly in respect of release of fraud claims.

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