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Court Approves Restructuring Plan for Failed Asset-Backed Commercial Paper

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On August 18, 2008, the Court of Appeal for Ontario affirmed the decision of the Ontario Superior Court of Justice approving a plan concerning failed asset-backed commercial paper (ABCP). 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 ground 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 legal proceedings 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, created 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* (CCAA), 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 nine 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 the invested amount in full.

Under the CCAA, 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 exception to these releases, as they believed that their right to sue the financial institutions that created and sold the ABCP (e.g,, the issuers, investment dealers and banks) was more valuable than what they could recover under the plan.

Some of these investors brought a last-minute motion before the bankruptcy court seeking to postpone the vote on the plan. 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; and that 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, approved the plan.

Amendment to Releases

The hearing regarding the fairness of the plan took place on May 12 and May 13, 2008. A few days after the hearing Justice Campbell released what may be called an interim decision on the plan, which made clear that he would not approve the plan unless the scope of the releases was

reduced to exclude fraud. At the same time, Justice Campbell stated that, in his view, the spirit of the CCAA would permit the release of negligence claims in the circumstances before him. In the result, Justice Campbell asked that the parties find a way to deal with fraud claims.

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

Court Approval of the Plan

(i) Ontario Superior Court of Justice

Justice Campbell approved the plan in a decision released on June 5, 2008: *ATB Financial v. Metcalfe & Mansfield Alternative Investments II Corp.*, [2008] O.J. No. 2265, 43 C.B.R. (5th) 269 (Ont. S.C.J.). Finding that the amended releases were fair and reasonable, he noted that the plan represents a highly complex and unique situation that could not succeed without the compromises it involved. In his 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," Justice Campbell 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.

(ii) Court of Appeal for Ontario

Justice Campbell's decision was appealed to the Court of Appeal for Ontario and was unanimously upheld: *Metcalfe & Mansfield Alternative Investments II Corp. (Re)*, 2008 ONCA 587. The Court of Appeal held that (i) as a matter of law, a plan under the CCAA may contain a release of claims against third parties, and (ii) Justice Campbell was correct in the exercise of his discretion to sanction the plan as fair and reasonable. The following are among the key points in the reasoning of the Court supporting these conclusions:

- The CCAA is remedial legislation and should therefore be liberally construed. Its remedial purpose is to facilitate compromises or arrangements between an insolvent debtor company and its creditors. When considering a proposed restructuring plan under the CCAA, the court must have regard not only to the individuals and organizations directly affected by the plan, but also to the wider public interest. Recognizing the wider purposes and objects of the CCAA is appropriate in this case, since the proposed plan is designed to bring about the financial viability of the Canadian ABCP market. Achieving this purpose necessitates the participation of *all* holders of ABCP.

- The CCAA is skeletal in nature, and does not contain a comprehensive code regarding what is permitted or barred, leaving judges to flesh out the details of the statutory scheme. While the powers of the court under the CCAA are not limitless, it is implicit in the language of the CCAA that the court has authority to sanction plans including third-party releases, provided that such releases are reasonably related to the proposed restructuring.

- There is a close connection between the plan and the releases in this case, since the parties to be released are necessary and essential to the plan; the claims to be released are rationally related to the purpose of the plan and necessary for it; the plan cannot succeed without the releases; the parties to be released are contributing in a tangible and realistic ways to the plan; and the plan will benefit not only the debtor companies but creditor noteholders generally.

- A compromise or arrangement under the CCAA should be treated as a contract between the debtor and its creditors. Therefore, parties are entitled to put into such a plan anything that could lawfully be incorporated into any contract. There is nothing to prevent a debtor and a creditor from including in a contract between them a term providing that the creditor release a third party. The term is binding as between the debtor and creditor.

- In insolvency restructuring proceedings almost everyone loses something. The compromise and arrangement proposed in this case affects the entire segment of the C$32-billion ABCP market and the financial market as a whole. Justice Campbell, as he was required to do, considered and balanced the interests of all noteholders, and not just the interests of the appellants, whose notes represent only about 3% of the total amount invested in the ABCP. He recognized that no plan of this size and complexity could be expected to satisfy all parties affected by it. In all of the circumstances, his decision that the plan is fair and reasonable should not be interfered with.

In coming to its decision, the Court of Appeal declined to follow a 1993 decision of the Québec Court of Appeal, *Michaud v. Steinberg*, 1993 CarswellQue 2055, in which it was held that the CCAA did not permit an arrangement under it to include third-party releases.

Application for Leave to Appeal to the Supreme Court of Canada

On September 2, 2008, a group of corporate investors in ABCP filed an application for leave to appeal the decision of the Court of Appeal to the Supreme Court of Canada. The basis of their application is reported to be that the case is of national importance since there are now conflicting decisions of appellate courts (i.e., *Metcalfe* and *Steinberg*) on an issue that will have an important impact on future insolvencies, namely, whether the CCAA permits an arrangement under it to contain third-party releases of the kind contained in the plan in this case. It is not known how soon the Supreme Court will render its decision on the leave application.