Insolvency: Is it on your radar?

BY JAMES REID, J.D

The number of insolvencies in Canada increased in 2019, and the economic conditions resulting from COVID-19 mean that a noteworthy jump in 2020 is likely unavoidable. Corporations facing insolvency will have to make critical decisions while keeping in mind not just the corporation, but also the various stakeholders that have an interest in those decisions.

Making critical decisions during insolvency will involve considering a number of possible outcomes that the corporation can pursue. It is important that the individuals responsible for the corporation's affairs have the clearest possible understanding of the scope of their obligations to the corporation and to its stakeholders. Board directors will additionally have to consider personal liability in making decisions, as exposure to personal liability becomes pronounced in insolvency.

This bulletin provides tips to help companies understand corporate insolvency, risk mitigation strategies, and the various regimes and options available to an insolvent corporation in Canada.

Tip #1: Recognizing Insolvency

Being able to recognize insolvency is a critical first step in making informed decisions on behalf of a corporation. Insolvency is a financial condition, and the corporation becomes insolvent at the point when it is unable to pay its bills or other costs and expenses as they become due, or where its debt exceeds the value of its assets. In the former situation, you would conclude that you are dealing with insolvency through a circumstantial analysis, while in the latter case it may be ascertainable from the corporation's balance sheet.

Directors and executives should be sensitive to early warning signs that a corporation is experiencing financial difficulties and could be operating in the realm of insolvency. Early indicators of insolvency may be external or internal.

Examples of external indicators include:

- persistent rumours
- industry downturns
- rising interest rates
- increased involvement in litigation
- difficulty making payments
- the bankruptcy of significant customers or vendors

Examples of internal indicators include:

- insufficient working capital
- poor credit control
- the departure of key employees
- inadequate succession planning

Although not all cases of insolvency will be traceable to a single catalyst, common causes include a corporation's overextension of credit, a high debt load compounded by depressed economic conditions, undercapitalization, delayed payments to suppliers as a form of credit to bridge short-term cash flow issues, and unfavourable monetary judgments following litigation proceedings.

It may be difficult for directors to recognize the signs of insolvency. For example, contingent liabilities, such as litigation or future environmental reclamation obligations, may not be reflected in the corporation's balance sheet. Additionally, when a corporation with debt facilities has breached or is close to breaching its financial covenants, it risks triggering a default under that credit facility. Such a default could result in any number of consequences, including an acceleration of the debt repayment terms. This may cause the insolvency of a financially distressed firm.

Key Take-Away

Directors and executives are responsible to ensure that financial statements and forecasts accurately reflect the solvency condition of the corporation and are reported in a timely and effective manner. In the current challenged economy, recognizing early warning signs that the corporation is experiencing financial difficulties is critical.

Tip #2: Courses of Action in Insolvency

There are a multitude of arrangements and proceedings a corporation can take in insolvency. The most common include restructuring, receivership and bankruptcy.

- **Restructuring** is the rescue of financially distressed corporations, maximization of the value of assets for creditors, and protection of wider stakeholder interests. A successful restructuring will often permit the corporation to continue in business, although it may sometimes result in the sale of a going concern to a third party. Restructuring can take place under a number of corporate and federal insolvency statutes, including:
  - The *Companies Creditors Arrangement Act* (Canada). The CCAA is restricted to larger corporations with liabilities in excess of $5 million and, while typically used for restructuring, the CCAA can also be used for going concern sale proceedings
  - The *Bankruptcy and Insolvency Act* (Canada). The BIA allows an insolvent corporation to make a commercial proposal to both secured and unsecured creditors. There is no financial threshold for making a proposal based on the value of outstanding claims against the corporation.
  - The *Canada Business Corporations Act* (Canada). The CBCA (and certain provincial counterparts) provide for a court-monitored process whereby a plan of arrangement may be used as a tool to restructure debt. There is no financial threshold for effecting a plan of arrangement, but there are particular statutory requirements that must be met and, as compared to the insolvency statutes, there is generally less flexibility with restructuring options under the CBCA.
- **Receivership** is designed to maximize the value of the assets available to the creditors of a debtor corporation's estate. A receivership under the BIA is a remedy available to secured creditors, where the corporation has defaulted on its loan payments, so that they can recover amounts outstanding under a secured loan.
- **Bankruptcy** is a legal process conducted under the BIA that provides a mechanism for the orderly liquidation of a bankrupt's estate and the distribution of the value of the assets in the estate to the bankrupt's creditors. There are three ways corporate bankruptcy proceedings may be initiated:
  - The corporation can voluntarily assign itself into bankruptcy.
  - The corporation's creditors can make an application in court to order the corporation into bankruptcy.
  - The corporation can be deemed automatically bankrupt where an attempt to negotiate a commercial proposal fails.

Often where there is no prospect of a corporation's survival, bankruptcy will be the preferred course of action. However, it is not uncommon for a restructuring or receivership proceeding to be converted into a bankruptcy after realizable assets have been sold and recoveries distributed.

Key Take-Away

While the choice of an insolvency proceeding is an important decision for a director to make, it will be largely influenced by the facts that present themselves at the outset. Factors that are taken into account include – but are far from limited to – the minimum debt requirement for the proceeding, the cost and time requirements, the consequences of failure, the necessity of court involvement, the value of the business, the viability of the business, and broader considerations concerning the nature of the stakeholders and the value of those stakeholder's claims against the corporation. It is also critical in the post-COVID environment to be fully knowledgeable about the impact of government packages related to potential insolvencies.

Tip #3: Dealing with the Demands of Insolvency

The environment within which a financially distressed corporation must operate is vastly different from the ordinary commercial activities of a business. For directors, seeing a corporation through insolvency can require a time commitment and expertise far beyond what was required when they were appointed. There may be a need to introduce changes to the board of directors. This is a fact-dependent decision, given that an *en masse* resignation of the board could well result in a loss of confidence by creditors and other stakeholders.

It is often necessary to keep key employees while working through insolvency proceedings, in order to maximize value and ensure that the corporation can either be restructured or sold as a going concern. Directors will need to be closely involved in considering the cost of retaining this expertise and in keeping employees working through any insolvency proceedings. Replacing or augmenting the existing management team may be required if creditors have lost trust in management or, in the case of restructuring, if the managers are thought to lack the expertise necessary to carry out a turnaround of the business.

In cases where the corporation is looking to restructure, directors and officers must come up with a strategy for the long-term viability of the business. This can include negotiating with multiple constituencies of creditors and stakeholders, procuring refinancing or alternate financing, and implementing downsizing. Existing corporate managers are unlikely to have expertise in restructuring and turnaround management, and directors of a financially distressed corporation may need to appoint a chief restructuring officer (CRO) in addition to hiring a financial advisor, among other industry experts, where appropriate.

Additional strategic appointments can include a special independent strategic board committee of outside directors who will serve the role of closely monitoring management's decisions. This is often seen as favourable by creditors of the corporation.

Key Take-Away

Directors of an insolvent corporation will need to take inventory of their personal competencies and those of management. A director must also assess whether they can devote the necessary time that will be required to oversee the corporation through an insolvency situation.

Additional appointments to the board or management may be required, as well as retaining professional advisors, including legal counsel, with the necessary expertise to effectively navigate insolvency proceedings.

Tip #4: Director Duties and Liabilities in Insolvency

Directors owe a common-law duty of care to act honestly and in good faith with a view to the best interests of the corporation. The nature and content of this fiduciary duty does not change when a corporation is insolvent. While the best interests of the corporation include consideration of, among other things, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment, directors must not favour the interests of any one group of stakeholders over others.

In complying with this duty, directors must balance the need to maximize the prospects of the corporation by carrying on business in the ordinary course with the risk that the corporation will not be able to satisfy newly incurred obligations. This is known as the "risk of trading while insolvent," and it is a critical decision that directors have to make in continuing operations while a corporation may be nearing insolvency.

In addition to the common-law duty owed to the corporation, directors have obligations under various statutes and may incur personal liability for non-compliance with these duties. The most significant sources include:

- where the corporation fails to remit and pay taxes, wages, pension contributions and other source deductions
- improper corporate actions while a corporation may be insolvent, such as paying out dividends while the corporation is unable to meet its liabilities
- industry-specific liabilities, including violating environmental or regulatory obligations

Different stakeholders will have divergent views as to the preferred direction and outcome of a financially distressed corporation, and some may be particularly strained in this economic downturn. However, directors of insolvent corporations must continue to act in the best interests of the corporation, and not favour any particular stakeholder.

Directors may face a heightened risk of liability for a corporation's non-compliance with various statutes as a result of lack of funds or otherwise. Thus, they should confirm how essential payments, such as source deductions, are continuing to be made by the corporation. Potential personal liability of directors for out-of-pocket costs normally only occurs when the corporation is insolvent and there are no assets to indemnify the directors.

On this note, directors should also confirm that indemnity agreements are in place during the normal course of business to ensure that they are indemnified by the corporation. They should verify that they are protected by directors and officers' insurance and that payments on that insurance are up-to-date. Director liability insurance may be difficult or too expensive for a company to obtain while a firm is financially distressed. Some corporations have a fixed sum held in trust and made available to directors if a claim is made against them. If no liability insurance is in place, directors should know if this type of fund exists. Other terms should be considered as well, such as the ability to seek independent legal advice paid for by the corporation. Finally, directors guiding a corporation through restructuring proceedings may be entitled to the benefit of a court-ordered charge on the assets of the corporation, as security for any indemnity provided by the corporation to its directors for their continuing to act through a restructuring proceeding.

Key Take-Away

Directors should ensure that protections have been put in place, so that in accepting the mandate to direct the corporation through an insolvency, a director is not being exposed to liability.

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