IN FACT AND IN LAW

AUGUST 2009

Construction and Surety Law

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CHANGES TO THE OBLIGATIONS OF A SURETY IN THE CONTEXT OF THE RESTRUCTURING OF AN INSOLVENT CONSTRUCTION COMPANY

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AS HIGHLIGHTED BY QUÉBEC COURTS, SURETIES ARE KEY PLAYERS IN THE CONSTRUCTION INDUSTRY. IN 2002, THE QUÉBEC COURT OF APPEAL ACKNOWLEDGED THEIR IMPORTANCE IN A DISPUTE BETWEEN A CONSTRUCTION COMPANY AND A SUPPLIER. THE COURT NOTED THAT THE CONSTRUCTION COMPANY'S LOSSES HAD BEEN EXACERBATED BY THE WITHDRAWAL OF ITS SURETY FACILITY.[1]

More recently, the Québec Superior Court established that the active participation of a surety in the restructuring of a company under the Canadian *Companies' Creditors Arrangement Act* (**"CCAA"**) was critical to determining whether a surety's obligations could be reduced under the terms of an arrangement.[2] Accordingly, in *Charles-Auguste Fortier inc. (Arrangement relatif à)*, the Court approved an arrangement under the CCAA, which provided for a partial release of claims against the surety of the debtor company.

The facts of *CAF* are as follows. Charles-Auguste Fortier inc. (**"CAF"**), a construction company that faced financial turmoil in June 2008, sought protection under the CCAA and negotiated a refinancing plan (the **"Plan"**). For the Plan to be viable, CAF required the participation of its surety AXA Assurances Inc. (**"AXA"**). The surety facility was necessary for CAF to bid on contracts with public owners. At the time of the initial order under the CCAA, AXA faced claims by sub-contractors of CAF totalling close to ten (10) million dollars.

AXA agreed to participate in the proposed Plan on condition that the claimants under labour and material payment bonds reduce their claims to 85% of their value. A small number of creditors argued that this condition was illegal - that the release of claims against third party guarantors was not permissible under the CCAA. Thus, the main issue was whether this position was correct. The Court concluded that such arrangements are acceptable when they are essential to the proposed restructuring.

1 *Ciment Québec inc. c. Stellaire Construction inc.* (21 mars 2002), Québec 200-09-002879-994 (C.A.), REJB 2002-32054; (8 novembre 1999), Québec 200-05-001606-958, AZ-00026066.

2 *Charles-Auguste Fortier inc. (Arrangement relatif à)*, 2008 QCSC 5388 [*CAF*]; *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36.

The Plan was considered by the Court to be fair and reasonable, and in line with principles of public order. It was clear that AXA played a central role in the Plan, since it had provided CAF with bonds required for several construction contracts, which were critical to its viability. Furthermore, GE Canada Equipment Financing G.P. and the Caisse Desjardins de Limoilou, two financial institutions that agreed to finance the Plan, required that AXA guarantee their advances. The Court stated that the Plan not only benefitted the debtor company, but also the other creditors, who were properly informed of AXA's release under the terms of the Plan.

The submissions of the opposing creditors were dismissed by the Superior Court, which distinguished on the issues the case law referred to by those creditors.[3] Of those cases, *Toiture P.E. Carrier inc. c. 2603373 Canada inc.* involved facts that had similarities to those in *CAF*. In *Carrier*, a plan of arrangement contemplated that claimants under labour and material payment bonds would receive 75% of their claims, on condition that they agree to suspend proceedings against the debtor and its surety. Unlike in *CAF*, the central issue was not whether the third party surety could obtain a partial release of claims, but whether a plan of arrangement under the CCAA could suspend the right of a claimant under labour and material payment bonds to institute proceedings against its guarantor.

In *Carrier*, the Québec Court of Appeal held that section 11 of the CCAA, which empowers judges to order the suspension of proceedings against a debtor company, does not give courts the discretion to suspend proceedings against third parties. The Court explained that a plan of arrangement binds a debtor and its creditors and does not extend to third parties, which have a distinct legal relationship with the creditor. Furthermore, it stated that construction sureties are intended to protect claimants under labour and material payment bonds against the risk of insolvency, and those claimants expect to be paid in full irrespective of the insolvency of the debtor. The Court also stressed that the power to create classes of creditors is limited by law and cannot be broadened so as to paralyze certain creditors from acting against the surety.

The Superior Court in *CAF* did not specifically address the abovementioned decision. The Court relied mostly on the principles outlined by the Ontario Court of Appeal in *Metcalfe & Mansfield Alternative Investments II Corp., (RE)* to support its decision.[4] The main issue in that case was whether a plan under the CCAA can provide for releases in favour of third parties. However, unlike in *CAF*, the release did not involve third party guarantors.

The facts in *Metcalfe* are as follows. The Appellants were holders of Asset Backed Commercial Paper (**"ABCP"**) and opposed a restructuring plan, principally on the basis that it required them to grant a release to third party financial institutions against whom they had claims for relief arising out of their purchase of ABCP Notes. The Appellants argued that this was not allowed under the CCAA. Although the Court rejected the position of the opposing creditors, it gave considerable thought to an argument put forward by them, which was based on s.5.1 CCAA. This section allows for releases in favour of directors of the debtor company in a compromise or arrangement. This provision was added to the CCAA in 1997.

The Appellants argued that the purpose of the legislation was to allow releases in favour of directors, to the exclusion of other categories of individuals not specifically mentioned in s.5.1 CCAA. This interpretation was based on the Latin maxim, *expressio unius est exclusion alterius*: to express or include one thing implies the exclusion of the other. The Court rejected this approach and asserted that the rationale behind the amendment was to encourage directors to remain in office during a restructuring, and not to address the rights and obligations of third parties.

[3] *Michaud c. Steinberg inc.*, [1993] R.J.Q. 1684 (C.A.), AZ-93011723; *Hydro Québec c. Meubles Dinec inc.* 2006 QCCA 747; *Toiture P.E. Carrier inc. c. 2603373 Canada inc.* [1994] RJQ 1540 (C.A.) [*Carrier*].

[4] *Metcalfe & Mansfield Alternative Investments II Corp.*, 2008 ONCA 587 [*Metcalfe*].

In rejecting the appeal, the Court explained that given the flexible and "skeletal" nature of the CCAA, and the broad meanings of the words "compromise" or "arrangement", the Act should be construed broadly and in accordance with its overall remedial purpose - to facilitate compromises or arrangements between an insolvent debtor company and its creditors. The Court explained that judges should sanction plans which contemplate third party releases "where those releases are reasonably connected to the proposed restructuring" [5], and clarified that such a connection exists where,

a) The parties to be released are necessary and essential to the restructuring of the debtor; b) The claims to be released are rationally related to the purpose of the Plan and necessary for it; c) The Plan cannot succeed without the releases; d) The parties who are to have claims against them released are contributing in a tangible and realistic way to the Plan, and; e) The Plan will benefit not only the debtor companies but creditor Noteholders generally. [6]

It was determined that the Appellants were being required to release their claims against certain financial third parties in exchange for what was anticipated to be an improved position for all ABCP Noteholders. Therefore, the Court approved the arrangement.

The question as to whether these principles apply equally in cases involving distinct categories of claimants could have also been raised in *CAF*. In *Abitibi-Bowater inc., Re*, a more recent decision of the Québec Superior Court, the Court adopted this approach. [7] In that case, a union argued that an arrangement under the CCAA was illegal and without effect, since it contemplated the suspension of early retirement benefits in a collective agreement. By way of introduction, the Court highlighted the principles outlined in *Metcalfe* and agreed that the purpose of an arrangement is to support the rehabilitation of a company. To achieve this objective, it is expected that creditors will concede to changes in their claims. Nonetheless, the Court found in favour of the union, and held that employees are a distinct class whose rights cannot be modified unilaterally, in spite of the broad economic purpose of the CCAA.

Considering all of these perspectives, the facts in *CAF* clearly supported a decision in favour of AXA, since, unlike in *Carrier*, the surety played a critical role in the restructuring of the debtor company. A refusal of the Plan by the Court would have been detrimental to the majority of creditors. It is important to note that 93.18% of the labour and material payment claimants' voted in favour of it, and of those who opposed the Plan, only two filed proceedings before the Superior Court. Given these facts, it would have been unreasonable to demand that all of the creditors approve the Plan, and to have expected the Court to reject it to appease these two claimants, whose claims were worth approximately 5%-10% of the total. Therefore, the Superior Court properly applied the principles outlined by the Ontario Court of Appeal to find in favour of AXA.

CONCLUSION

The *CAF* decision will likely provide sureties with a strategic advantage in the restructuring of a company under the CCAA, given that the question as to whether releases of guarantors are permitted under the CCAA was answered affirmatively by the Court. However, because of the wide discretion granted to judges under the CCAA, the conflicting opinions of courts and certain authors, and the evolutionary nature of the law, not all situations will necessarily be treated in the same manner. Nevertheless, it is reasonable to expect that a court will approve an arrangement, which contemplates the release of claims in favour of a surety, where the surety's role is essential to the restructuring, and where the large majority of creditors agree to these terms.

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This text was originally printed for the IADC.

[5] *Ibid.* at para 43.

[6] *Ibid.* at para 71.

[7] *AbitibiBowater inc., Re* (4 mai 2009), Montréal 500-11-036133-094 (Qc. Sup. Ct.), 2009 CarswellQue 4284.

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