THE 'CRITICAL SUPPLIER' IN QUÉBEC JURISPRUDENCE AND A QUÉBEC PERSPECTIVE ON *INDALEX*

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A. THE 'CRITICAL SUPPLIER' IN QUÉBEC JURISPRUDENCE

Since the coming into force of the 2009 amendments to the *Companies Creditors' Arrangement Act* ("CCAA"),[1] Québec courts have not yet seen an application of the new provision on critical suppliers[2]. However, a look back at case law prior to 2009 demonstrates an openness to the concept of critical suppliers in the context of a CCAA restructuring. Moreover, a review of this jurisprudence may provide some insight into the way that Québec courts will address the issue of critical suppliers in the future.

A look back at this case law reveals that, prior to section 11.4 CCAA becoming legislation, Québec courts were ordering the continued provision of goods and services where to do so would further the remedial purposes of the Act. More specifically, where an interruption in the provision of goods and services would render the debtor company unable to restructure, Québec courts have historically been willing to make the orders necessary to ensure the continuation of services to the debtor.

1. Critical Suppliers in Québec prior to 2009:

The statutory discretion of the courts in insolvency matters is a distinguishing feature of this area of the law. Nowhere is this exercise of judicial discretion more evident than in the case of restructuring companies under the CCAA. Indeed, long before the reforms of 2009, it was relatively common for judges sitting in insolvency matters to authorize a restructuring company to pay suppliers who were deemed to be critical to the continuation of their operations the amounts that were owed to them prior to filing.[3]

Some cases involving critical vendors, rendered long before the reform, demonstrate a clear concern for the integrity and the ultimate goals of the CCAA restructuring process. In an early decision,[4] the Québec Superior Court enjoined a supplier from cutting off the gas supply to a debtor company unless all arrears were paid in full. The Court held that to permit the supplier to stop providing service would run contrary to the spirit of insolvency legislation.[5] Moreover, to tolerate the cutting off of service would be to allow the utility company to exercise undue pressure on the trustee in order to receive preferential treatment of its claim.[6] On display in this case is a deep desire to balance the debtor's ability to continue to receive critical goods and services with the principle of the equitable treatment of creditors.

More recent jurisprudence, for its part, is demonstrative of a trend in dealing with suppliers deemed critical to the debtor company's success: the Court has often authorized the payment dsby the debtor of certain suppliers the amounts due to them up to a pre-determined

[1] RSC 1985, c C-36.
[2] We are aware of no reported cases in Québec as at August 31, 2012 discussing the issue since the new provisions of s.11.4 CCAA came into force in September 2009.
[3] Philippe H. Bélanger & Sylvain Rigaud, *La réforme en matière d'insolvabilité : nouveautés et codification de pratiques existantes*, (Cowansville : Éditions Yvon Blais, 2011) at 144.
[4] *Wynden Can. Inc. v. Gaz Métro*, (1983), 44 C.B.R. (N.S.) 285.
[5] *Ibid* at 287.
[6] Ibid. For another early illustration of this principle, see *Plastiques Valsen Inc. (In re) : Gaz Métropolitain Inc.* v. *St-Georges*, J.E. 81-494.

amount. In these cases, the critical supplier was identified by the debtor and approved or supervised by the monitor.[7]

Consider the following examples:

<u>*Le Naturiste J.M.B. Inc. v. KPMG Inc.*, AZ- 50269280 (2004 QC SC):</u>

> The Petitioner was authorized to pay up to $100 000 for goods and services actually supplied to the Petitioner prior to the date of the Order, including payments in respect of outstanding documentary credits or deposits, if, in the opinion of the Petitioner and of the Monitor, the supplier is critical to its business and ongoing operations.

<u>*Strategy First Inc. (Arrangement relatif à)*, 2004 Can LII21470 (QC SC):</u>

> The Petitioner can pay all or part of the undisputed prepetition claims of certain critical suppliers of goods and services with the consent of the Monitor, provided that such payments are deemed necessary to avoid serious disruptions of the Petitioner's business, and provided that these payments do not exceed $100 000 in the aggregate.

Another line of case law pre-2009 shows the Court dealing with suppliers who, prior to the filing, increase the price of the goods and services they supply, presumably with knowledge of the financial situation of the debtor. When asked to honour these new 'agreements' Québec courts have been very reticent to do so.

In *Lagran Canada Inc. (Arrangement relatif à)*,[8] the debtor company was in the business of manufacturing seatbelts, primarily for the automobile industry. Investa was the supplier of 96% of the wire provided to the debtor and an interruption of the supply of this wire would result in the immediate shutdown of the company's activities.[9] Prior to the commencement of CCAA proceedings, the debtor began paying Invista 200% of the cost of the merchandise and subsequently was able to convince Invista to accept 150% of the price. As a result, Invista asked the Court to amend the Initial Order to reflect the debtor's new engagement to pay 150% of the price in return for the supply of wire.

The Superior Court refused Invista's request, holding instead that the debtor's decision to pay 150% of the price of the goods did not reflect an agreement arrived at between the parties, but rather, an act of self-preservation in light of Invista's unilateral refusal to comply with the earlier agreement.[10] Moreover, the Court was of the view that to grant the amendment sought by Invista would have the effect of rendering CCAA orders useless. Indeed, all a supplier would have to do would be to mention in their contracts that all sums due would have to be paid prior to delivery in order to circumvent the effect of the filing of a Notice of

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[7] Philippe H. Bélanger & Sylvain Rigaud, *La Réforme en Matière d'Insolvabilité : nouveautés et codification de pratiques existantes*, (Cowansville : Éditions Yvon Blais, 2011) à la p.145 [*Bélanger et Rigaud*].
[8] 2005 CanLII2781 (QC CS).
[9] *Ibid* at para 8.
[10] *Ibid* at para 32.

Intention.[11]

Again, this decision is indicative of the courts' desire to respect the fairness and the general objectives of the CCAA. These principles have guided Québec courts in deciding matters related to critical suppliers.

2. Section 11.4 and the Québec Courts Going Forward:

Section 11.4 of the CCAA reads as follows:

> **11.4** (1) On application by a debtor company and on notice to the secured creditors who are likely to be affected by the security or charge, the court may make an order declaring a person to be a critical supplier to the company if the court is satisfied that the person is a supplier of goods or services to the company and that the goods or services that are supplied are critical to the company's continued operation.
>
> (2) If the court declares a person to be a critical supplier, the court may make an order requiring the person to supply any goods or services specified by the court to the company on any terms and conditions that are consistent with the supply relationship or that the court considers appropriate.
>
> (3) If the court makes an order under subsection (2), the court shall, in the order, declare that all or part of the property of the company is subject to a security or charge in favour of the person declared to be a critical supplier, in an amount equal to the value of the goods or services supplied under the terms of the order.
>
> (4) The court may order that the security or charge rank in priority over the claim of any secured creditor of the company.

Section 11.4 CCAA does not provide much direction with regards to the definition of a critical supplier. However, it seems as though the existing case law in Québec militates in favour of a relatively restricted class of suppliers being considered 'critical'. In *Lagran,* for example, to cut-off the supply of these goods would have lead the debtor to immediately close its doors. This suggests that the threshold will be relatively high for Québec courts in determining whether a vendor is critical to the on-going operations of the debtor.

Moreover, while the above-mentioned case law demonstrates that Québec courts have been willing to recognize the importance of critical suppliers to a successful restructuring, the future application of section 11.4 CCAA will mark a departure from established jurisprudence in the province. While article 11.4(3) directs the Court to grant a charge over the property of the debtor in favour of the critical supplier, none of the jurisprudence in Québec prior to this provision's enactment included the granting of such a charge.

However, it is worth noting that in a judgment[12] that pre-dated the amendments to the CCAA by only a few months, the Québec Court of Appeal held that Hydro-Québec was entitled to request a guarantee of payment of $42 000 for the services it would provide to the debtor

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[11] *Ibid* at para 55.
[12] *Hydro-Québec* v. *Fonderie Poitras ltée*, 2009 QCCA 1416.

through its restructuring.[13] The idea espoused in this judgment is that the supplier bore all the risk of continued provision of service and that the guarantee was necessary to ensure payment. [14] Thus, even in the absence of specific legislation authorizing it, the Court recognized the importance of granting a supplier some sort of guarantee when dealing with an insolvent debtor.

It is also important to note that the courts are likely to use methods other than those prescribed at section 11.4 CCAA when dealing with critical suppliers. There is ample authority to support the proposition that the enactment of section 11.4(3) does not relieve the Court of its general discretion to permit a debtor to make pre-filing payments to a critical supplier where the latter does not seek the creation of a charge in its favour.[15] As such, we would imagine that such orders will continue in Québec.

Some commentators suggest that a combined reading of section 11.01 CCAA (no order of the Court has the effect of prohibiting a supplier to require immediate payment for goods or services provided after the initial order) and section 34 CCAA (prohibition against termination of contracts) should bring the court to consider that in order for a supplier to be determined to be a "critical supplier" under section 11.4 CCAA, (a) this supplier should not be contractually bound to provide goods and services to the debtor, and (b) those goods and services must be essential to the continuation of the debtor's operations[16].

Also, those commentators have criticized the broader interpretation given by Madam Justice Pepall in *Canwest* and noted[17] that the courts would be well-advised to use their discretion to grant such orders sparingly so as to avoid the preferential treatment of some suppliers over others. Such differential treatment of creditors of the same category should be used only where there are serious reasons to warrant such an order.[18]

3. Conclusion:

Case law on critical suppliers in Québec pre-2009 is demonstrative of judges using the main goals of the CCAA in rendering orders which will, at once, seek to maximize the possibility for the debtor company to complete a successful restructuring while also respecting the goals of the legislation itself. As we move forward, it will be interesting to see how the courts in Québec will react to the codification of this concept which has been part of CCAA jurisprudence for some time.

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[13] *Ibid* at para 90.
[14] *Ibid* at para 110.
[15] See eg : *Northstar Aerospace, Inc. (Re)*, 2012 ONSC 4546 at para 11; *Cinram International Inc. (Re)*, 2012 ONSC 3767 at para 66; *Canwest Global Communications Corp. (Re)*, 2009 CanLII 55114 at paras 42-43.
[16] *Bélanger et Rigaud, supra* Note 5 at 148.
[17] *Bélanger et Rigaud, supra* Note 5 at 149.
[18] *Ibid*.

B. SUPERIOR COURT REFUSES TO IMPORT INDALEX DECISION INTO QUÉBEC LAW

On April 20, 2012, Justice Mongeon of the Québec Superior Court rendered an important decision in the restructuring of the White Birch Paper Company ("White Birch").[19] In the judgment, the Court addressed the application of the Ontario Court of Appeal's decision in *Indalex (Re)* in the province of Québec.

1. Background:

White Birch is a manufacturer of newsprint and specialty paper with operations in both Québec and Virginia. In early 2010, the company placed itself under the protection of the CCAA. At the time the initial order was issued, White Birch's pension plans were in a severe solvency deficit position. The initial order provided, among other things, for the suspension of "special payments" to its pension plans. It also released White Birch from any statutory, fiduciary or "common law" obligations and stated that no trust, whether express, tacit, or deemed, would be recognized. Finally, the initial order created a super-priority charge to secure interim financing ("DIP Financing") in order to enable the company to continue its operations during the restructuring.

Some 21 months after the initial order was granted, the union (CEP), the non-union pension committees, and a group of retirees each petitioned the Court for a declaration that any sums owed by White Birch to the pension plans be declared a claim ranking ahead of the claim of the DIP lender. Furthermore, they alleged that the company had sufficient liquidity to reinstate the special payments to the pension plans and asked for an order to this effect.

2. Petitioners' Position:

The petitioners sought to persuade the Court to apply the Ontario Court of Appeal's decision in *Re Indalex*[20] in Québec. It was argued that section 49 of the Québec Supplemental Pension Plans Act ("SPPA"),[21] similarly to the Ontario Pension Benefits Act ("PBA"),[22] created a statutory deemed trust over unpaid contributions by the employer, including special payments. Furthermore, it was alleged, based on *Indalex*, that the onus was on White Birch to show that the provincial legislation must yield to the general objectives of the federal CCAA.

3. The *Indalex* Decision:

The debate between the petitioners and White Birch centered mainly around the application of the *Indalex* decision. In April 2009, Indalex was granted protection under the CCAA. It received DIP Financing from a syndicated group of lenders in return for the usual super-priority charge ranking ahead of any secured claim, trust, or other statutory and contractual charges. The company was also the administrator of two defined benefit pension plans, one for the employees and the other for the executives, both of which showed significant solvency

[19] 2012 QCCS 1679.
[20] 2011 ONCA 265 [*Indalex*].
[21] RSQ,cR-15.1,s.49.
[22] 1990,cP.8.

deficits. Ultimately, Indalex sought authorization to sell its assets and distribute the proceeds to the DIP lenders. The unions, and some of the retirees' representatives, contested the proposed distribution of assets.

The Ontario Court of Appeal unanimously overturned the lower court's decision holding instead, pursuant to section 57(4) of the *Pension Benefits Act*, that the solvency deficit of the employees' retirement plan was subject to a deemed trust and, therefore, that the sum required to offset this deficit had to be carved out of the debtor's estate. According to the Ontario Court of Appeal, the provincial statute continued to apply in matters of insolvency and restructuring absent an express provision in federal legislation to displace it. Ultimately, it was not shown that the PBA and the CCAA were incompatible. As a result, the PBA could be applied even though the debtor had come under the protection of the CCAA. Furthermore, since the initial order did not state that the DIP loan would rank ahead of the deemed trust, the trust had to take priority over the DIP super-priority.

The Ontario Court of Appeal further ruled that the deemed trust provision under the PBA could not apply to the executives' retirement plan because the plan was not wound up at the time the initial order was issued. Rather, the Court held that the company, as administrator of the pension plans, did nothing to protect the interests of the beneficiaries and, consequently, was in breach of its fiduciary duty. The Court resorted to equitable principles to remedy the situation, stating that Indalex had breached its obligations as constructive trustee of the pension plan. According to the Court, the constructive trust in favour of the plan beneficiaries had priority over the charge granted in favour of the DIP lenders.

The Ontario Court of Appeal's decision did not go unnoticed and, in fact, the Ontario courts had a chance to revisit the *Indalex* decision in *Re Timminco.*[23] It is worth noting that the Superior Court in *Timminco* refused to apply the *Indalex* decision. In the words of Justice Morawetz:

> [49] In the absence of the court granting the requested super priority, the objectives of the CCAA would be frustrated. It is neither reasonable nor realistic to expect a commercially motivated DIP lender to advance funds in a DIP facility without super priority. The outcome of a failure to grant super priority would, in all likelihood, result in the Timminco Entities having to cease operations, which would likely result in the CCAA proceedings coming to an abrupt halt, followed by bankruptcy proceedings. Such an outcome would be prejudicial to all stakeholders, including CEP and USW.
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> [50] The analysis in the present motion is the same as that set out in *Timminco Limited (Re)*, 2012 ONSC 506 (CanLII), 2012 ONSC 506. The outcome of this motion is consistent with that analysis. I am satisfied that bankruptcy is not the answer and, in order to ensure that the objectives of the CCAA are fulfilled, it is necessary to invoke the doctrine of paramountcy such that the provisions of the CCAA override those of the QSPPA and the OPBA [*Emphasis ours*].

[23] 2012 ONSC 948. Leave to appeal denied: 2012 ONCA 552.

4. Special Payments Under the SPAA: Was a Trust Created?

Mr. Justice Mongeon of the Québec Superior Court came to a different conclusion than the Ontario Court of Appeal. He held that, as distinct from the PBA in Ontario, the Québec SPPA does not create a trust under Québec law. The relevant provision reads as follows:

> 49. Until contributions and accrued interest are paid into the pension fund or to the insurer, they are deemed to be held in trust by the employer, whether or not the latter has kept them separate from his property.

While the BIA used to contain a presumption which made it unnecessary to create a true trust, both the BIA and the CCAA now only recognize true trusts, with limited exceptions. Therefore, according to Justice Mongeon, under the current regime, the existence of a deemed trust in the statute merely creates a presumption that a trust exists. For a trust to actually exist, all of the constituent elements under the applicable law must be present.

Furthermore, the Court relied on the Supreme Court's decision in *Century Services Inc. v. Canada (Attorney General)*[24] to the effect that, since section 37 does not explicitly protect this deemed trust, it is of no force and effect in the context of an arrangement under the CCAA. In other words, the deemed trust under the SPPA is rendered ineffective against a debtor under the CCAA.

Since no deemed trust existed, a trust would only have been created in favour of the petitioners if it had to satisfy the requirements of a true trust under provincial law. Indeed, the notion of constructive trust, which was fundamental in *Indalex*, is unknown to Québec law. However, in this case, the fact that no funds were transferred or set aside for the special payments led Justice Mongeon to conclude that no true trust was created. White Birch had not transferred anything and had, in fact, maintained complete control over the property supposedly affected by a trust. The sums owed were intermingled with the rest of the company's money and were in no way separated or removed from the company's control.

5. Was White Birch in Breach of its Fiduciary Obligations?

Justice Mongeon began by drawing an important distinction between the situation in *Indalex* under the PBA and the way in which pensions are administered in Québec. Most notably, unlike the situation in Indalex in which the company administered the plans, when a pension plan is registered in Québec, it must be administered by a pension committee. Therefore, once the pension plan has been registered, the employer no longer has any fiduciary obligation to the pension plan. As a result, the Court held that, in contrast to the situation of Indalex, White Birch had not taken up the mantle of an administrator or manager of the pension plans in question and, therefore, could not be found to be in breach of any fiduciary obligation. Moreover, since the constructive trust does not exist under Québec law, White Birch, unlike the situation in Indalex, could not be considered a 'constructive trustee'.

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[24] 2010 SCC 60.

6. Rejection of *Indalex*:

Mr. Justice Mongeon wrapped up his discussion of *Indalex* by referring to recent cases in Ontario which have refused to find that the deemed trust under the PBA should take priority over CCAA charges. The decision of Justice Morawetz in *Re Timminco*[25] is cited for the principle that ordering a debtor to continue making special payments, where this would have the effect of pushing a viable company into bankruptcy, would frustrate the purpose of the CCAA. Consequently, Mr. Justice Mongeon was of the opinion that even if the Court had come to the conclusion that a trust was created in favour of the petitioners, the SPPA would be rendered inapplicable pursuant to the doctrine of paramountcy.

Ultimately, this rejection not only of the decision in *Indalex*, but also the existence of a trust flowing from section 49 SPPA which could be set up against the debtor, means that the special payments suspended by the initial order rank as mere unsecured claims.

7. The "Floating Charge":

The petitioners argued, in the alternative, that if section 49 SPPA does not create a trust which is effective against the DIP lender, this provision could create a floating charge over the debtor's assets. Justice Mongeon cited the Supreme Court of Canada, which describes the floating charge in the following terms:

> [...] A floating security is not a specific mortgage of the assets, plus a licence to the mortgagor to dispose of them in the course of his business, but is a floating mortgage applying to every item comprised in the security, but not specifically affecting any item until some event occurs or some act on the part of the mortgagee is done which causes it to crystallize.[26]

The argument here was that the effect of the floating charge would be that the special payments would rank behind the super- priorities granted in the initial order but ahead of other claims, whether secured or not. However, this argument failed because the floating charge theory does not apply under Québec law.

8. The *Res Judicata* Argument:

In response to the argument that the previous orders of the Court were final and could not be changed or altered, the Court noted that there was a comeback clause which seemed to permit adjustments to be made to the initial order. However, the Court observed that important decisions had been made on the basis of those orders. In this case, the interim lender had agreed to lend tens of millions of dollars to White Birch to keep the company afloat. Furthermore, the initial order was not issued without the petitioners' knowledge. Justice Mongeon concluded that the extended period of time that elapsed between the initial order and the motion before him (21 months) was not due to ignorance of the facts, but rather, to the concerted effort by the petitioners to have the principles of *Indalex* applied in

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[25] *Supra* note 21.
[26] *Alberta (Treasury Branches)* v. M.*R.N.; Toronto Dominion Bank v.M.R.N.*, [1996] 1 SCR 963 cited at para 204 of the decision.

Québec.

While the cash flow of White Birch had clearly improved, Justice Mongeon held that if he ordered White Birch to reinstate the special payments, this would give the pension plans an unfair advantage over White Birch's other creditors whose claims were stayed. Indeed, the increased liquidity of the company was due in large part to the stay obtained under the CCAA because it permitted the company to suspend the payment of roughly $900 million in debt.

9. Conclusion:

At this time, it is still unclear what the impact of the decision in *Indalex* will be. *Indalex* was heard by the Supreme Court of Canada on June 5, 2012 and its judgment is awaited with great anticipation.

On May 9, 2012, the Association of Retired Employees of White Birch - Stadacona applied for leave to appeal Justice Mongeon's decision. However, the inscription for appeal has been cancelled and the Union seems to be desisting from its appeal. As a result, it seems that, at least for now, the fate of *Indalex* in Québec has been decided. While *Indalex* was partially decided on the basis of the particular facts at hand, for example the lack of notice provided to the pensioners, Justice Mongeon's decision seems to rely largely on the specificities of Québec law. As such, while the Supreme Court's decision in *Indalex* will be hotly debated in Québec, the issue of its application in this province is settled- at least for now.

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