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Re-defining the Role of the Canadian Judiciary in Bankruptcies and Receiverships

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RECENT DEVELOPMENTS

Re-Defining the Role of the Canadian Judiciary in Bankruptcies and Receiverships

*Stephanie Ben-Ishai**

1. INTRODUCTION

Consistent with prevailing neo-liberal ideologies, the Canadian bankruptcy system has become increasingly privatized. Parties have been left to bargain in the shadow of the law to determine which businesses will be rehabilitated, and how best to deal with those businesses' financial difficulties. The Canadian judiciary facilitates the process, but it is largely the debtor corporation and its major creditors that drive it. Situated in this context, this commentary considers the broader issue of how contracts entered into by a debtor corporation prior to bankruptcy will be treated on the bankruptcy of the debtor corporation. It focuses in particular on successor employer liability issues. The treatment of employees in bankruptcy brings into focus the potential inequities that can surface when the rights of third parties can be negotiated away without their consent, in what is, in practice at least, an increasingly privatized bankruptcy process.

A significant group of stakeholders in any corporate bankruptcy is the debtor corporation's employees. Employees' wages and benefits are negotiated in their employment contracts and collective agreements. Once wages and benefits have been agreed upon, employees are generally not in a position to alter the agreed upon wages and benefits—in particular, when the financial situation of their employer changes. Employees usually do not know if their employer is likely to go bankrupt and are generally not in a position to demand risk premiums. Accordingly, certain provisions are in place in Canadian labour legislation and in bankruptcy legislation to protect employees. The protection provided by these provisions is threatened when a receiver is put into place to

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realize the assets of the employer corporation. In an effort to realize on such assets, a receiver may continue the employer's operations with a view to selling the corporation as a going concern and may continue to employ the debtor corporation's employees. However, a common practice has developed in Canada, where receivers, who are increasingly court appointed and derive their authority and powers from a court order,¹ attend on a bankruptcy judge *ex parte* with a draft order agreed upon by the debtor corporation and the major creditors. The draft order gives the receiver extensive powers, and at the same time limits the nature of the receiver's liability to employees and unions, even if they do continue to operate the former employer's business.²

The recent Ontario Court of Appeal decision in *GMAC Commercial Credit Corp. v. TCT Logistics Inc.*³ ("TCT") signifies a shift by Canadian courts in the direction of a principled framework for grappling with the relationship between the roles and jurisdiction of private parties, receivers, trustees, bankruptcy judges, and provincial labour boards in dealing with employees' rights when a corporation is in financial trouble. The Ontario Court of Appeal in *TCT* considered: (1) whether the bankruptcy court⁴ has the authority to effectively immunize a receiver or a trustee

¹ See Peter P. Farkas, "Why Are There So Many Court-Appointed Receiverships?" (2003) 20 Nat'l Insolv. Rev. 37. Over the last decade the receivership landscape has changed significantly from a situation where the majority of receiverships were private appointments, usually initiated by Canadian banks, to the current situation where the majority are court appointed.

² Other provisions that are generally provided for in a receivership order include: authorization for the receiver to take possession of the debtor's assets and to carry on its business; authorization to market and sell a debtor's business and/or assets subject to court approval; authorization to conduct an investigation into the debtor's financial affairs; a requirement that all books, records and information related to a debtor's affairs be delivered to the receiver, upon such request; provisions that deem the receiver not to have liability for a debtor's existing environmental problems; provisions that "stay" third parties from interfering with the debtor's business, including terminating agreements and cutting off utilities; authorization to borrow funds to allow the business to operate during the receivership period; and limitations on a receiver's liability, except in the case of gross negligence and willful misconduct. *Ibid.*, at 3.

³ (2004), 2004 CarswellOnt 1284, 2004 C.L.L.C. 220-029, 185 O.A.C. 138, 48 C.B.R. (4th) 256, 40 C.C.P.B. 45, 238 D.L.R. (4th) 677 (Ont. C.A.).

⁴ Unlike the American context, in Canada there is no actual "bankruptcy court" or "bankruptcy judge." See Iain Ramsay, "Interest Groups and the Politics of Consumer Bankruptcy Reform in Canada" (2003) 53 U.T.L.J. 379 at 393, 399. All Superior

in bankruptcy appointed under the *Bankruptcy and Insolvency Act*⁵ ("BIA") from the obligations of a successor employer where that practitioner operates the debtor's business in order to sell it as a going concern; and (2) the test to be applied by the bankruptcy court for granting a union leave to bring successor employer proceedings before the Ontario Labour Relations Board ("OLRB").

The majority reasons in *TCT*, written by Feldman J.A., with Cronk J.A. concurring, reached two significant conclusions. First, the bankruptcy court does not have the authority to determine whether a receiver or trustee carries on the business of a debtor as a successor employer, rather the OLRB has exclusive jurisdiction to make this determination. Second, the bankruptcy court, in its exercise of supervisory control, can deny leave to bring successor employer proceedings against a trustee or receiver before the OLRB based on factors relevant to the bankruptcy and the best interests of all stakeholders.

On the basis of these two conclusions, the majority remitted the matter back to the bankruptcy court, which had previously denied the appellant union leave to commence successor employer proceedings before the OLRB. The bankruptcy court was directed to determine whether to grant leave on the basis of the test articulated by the majority.

The third member of the panel in *TCT*, MacPherson J.A., dissented on the second conclusion reached by the majority, as he would have granted the appellant leave to commence proceedings before the OLRB.

2. FACTS

The *TCT* proceedings arose out of three OLRB applications filed by the Industrial Wood and Allied Workers of Canada, Local 700 (the "Union") without leave of the bankruptcy court that was overseeing the interim receivership of TCT Logistics Inc. and related companies (collectively "TCT"). The Union was the exclusive bargaining agent for the

Court judges in the provinces and territories have jurisdiction in bankruptcy. Certain Superior Court judges handle a larger number of bankruptcies and have developed a specialization in commercial bankruptcy. For the purposes of this article, the terms bankruptcy court and bankruptcy judge are used in the same manner as in the *TCT* reasons.

⁵ R.S.C. 1985, c. B-3.

70 employees at one of the warehousing facilities located on Horner Avenue operated by TCT.

TCT became insolvent in January 2002, and moved under s. 47 of the BIA and s. 101 of the *Courts of Justice Act*⁶ for an order appointing KPMG Inc. as interim receiver over the assets of TCT. The order granting interim receivership powers subject to court supervision was granted on January 24, 2002 (the “Order”). Among other standard provisions, the Order provided that KPMG Inc. would shut down and sell TCT’s businesses and assign TCT into bankruptcy. The Order also provided that KPMG Inc. was empowered to engage, retain, discharge, or terminate employees of TCT, but any such actions would not establish it as a successor employer under the Ontario *Labour Relations Act, 1995*⁷ (“LRA”) or any other provincial or federal statutes. Further, no actions or proceedings could be commenced against KPMG Inc. in any court or other tribunal without leave of the bankruptcy court.

Following its appointment as interim receiver, KPMG Inc. entered into an asset purchase agreement with Spectrum Supply Chain Solutions (“Spectrum”)—a corporation formed by the former management of TCT. Spectrum set up operations in a Toronto neighborhood that was located in close proximity to TCT’s Horner Avenue warehouse, with essentially the same customer base. As part of the asset purchase agreement, where Spectrum purchased TCT’s assets with the exception of two warehouses, KPMG Inc. retained Spectrum to manage the wind down of the two warehouses. One of these was the Horner Avenue warehouse that gave rise to this appeal. KPMG Inc. terminated all unionized employees at the Horner Avenue warehouse, although some were later rehired by Spectrum to work at the new Spectrum warehouse, without regard to Union seniority.

The Union alleged in its applications to the OLRB that Spectrum was incorporated for the sole purpose of acquiring TCT’s warehousing assets and that the purpose of the asset purchase agreement between Spectrum and KPMG Inc. was to oust the Union and to operate TCT’s warehousing business in Toronto under substantially the same management but without a union.

⁶ R.S.O. 1990, c. C.43.

⁷ S.O. 1995, c. 1, Sched. A.

3. COURT OF APPEAL DECISION

(a) **BIA Receivership Orders Are Not Immune to OLRB Scrutiny**

(i) *Majority Reasons*

The three members of the Court of Appeal panel in *TCT* all agreed that ss. 69(12) and 114(1) of the LRA give the OLRB the unequivocal and exclusive jurisdiction to decide the successor employer issue for labour relations purposes in every case. Accordingly, the standard practice of inserting clauses in receivership orders that exclude successor employer liability cannot serve to immunize receivers' actions from review by the OLRB. The Court reached this conclusion after reviewing ss. 47(2) and 14.06(1.2) of the BIA. These provisions, read together, give the bankruptcy court the power to direct the receiver to carry on the business of the debtor and at the same time provide that the receiver will not be liable for any obligations incurred by the debtor corporation before the date of bankruptcy. However, the BIA provisions are silent on any obligations that the receiver may incur following his or her appointment, which may include successor employer liability under the LRA. Accordingly, s. 72 of the BIA, which provides that the BIA will only abrogate or supercede provincial law if the law is in conflict with the BIA, is not applicable. That is, the language of the BIA provisions does not conflict with the successor employer provisions in the LRA and accordingly does not abrogate or supercede them.

(ii) *Commentary*

The Court of Appeal's reluctance to allow receivership orders drafted by the parties and "rubber stamped" by the bankruptcy court to interfere with the mandatory nature of successor employer liability without the scrutiny of the OLRB is justified given the greater potential for information asymmetry. The purpose of the successor employer provisions in the LRA is to accord protection to unions from employers who might attempt to disenfranchise them through corporate manipulations. The theoretical underpinnings for successor employer provisions may be explained in part by human capital literature.⁸ This literature empha-

⁸ See for example, Gary S. Becker, *Human Capital*, 2d ed. (New York: National Bureau of Economic Research, 1975).

sizes the need to compensate employees for firm training that enhances the employee's productivity only within the firm, but does not make the employee more productive to other employers.⁹ As both the employee and the employer have invested in this form of firm training, a fair contract is one where they share the costs and benefits, and in many instances may account for a divergence between the employee's actual wages and the wages that the employee could seek in the market.¹⁰ Because the employer will generally have an informational advantage in determining the firm-specific value of a worker's time, a role for unions as monitors of the employment relationship exists. The union's monitoring function is necessary because the employer has an incentive to reduce wages whenever they exceed the wages that the employee could seek in the market.¹¹

In situations where a trustee or a receiver runs a business for a period of time they may have a greater incentive, as compared with the original employer, to reduce wages so as to generate a surplus that can be realized in the ultimate sale of the business or the assets. Given that the trustee or receiver will be exiting the employment relationship in a relatively short period of time, they will be less concerned about the reputational impacts of opportunistic wage cutting. Further, the trustee or receiver will have an information advantage regarding the circumstances of the debtor corporation. Accordingly, a mandatory successor employer rule that can not be altered by a bankruptcy court order appointing a receiver and that requires the trustee or receiver to honour the debtor corporation's collective agreement is optimal.

At the same time, the importance of protecting employee rights needs to be balanced against the central role that the trustee and/or the receiver plays in the bankruptcy process. Practitioners have argued that the danger with potential successor employer liability is that it will be difficult to attract qualified professionals to serve as receivers or trustees, and that where practitioners take on such appointments they will act too cautiously.¹² In the context of a healthy, robust economy, the end of the

⁹ *Ibid.*, at 26-37.

¹⁰ *Ibid.*

¹¹ Keith H. Hylton & Maria O'Brien Hylton, "Rent Appropriation and the Labor Law Doctrine of Successorship" (1990) 70 B.U.L. Rev. 821 at 835-836 (Lexis).

¹² *Supra*, n. 3 at paras. 55-56.

20th century witnessed a similar concern about the personal liability that was being placed on directors and officers, as well as gatekeepers such as lawyers, underwriters, and most notably, auditors.¹³ The response to the so-called liability crisis, which resulted in a reduction of professional liability on many fronts, has assisted in creating an environment in which many professionals have been lax about their conflicts of interest, have succumbed to management pressure to approve financial documents in a certain way, and overall have not performed their jobs of being independent scrutinizers of financial documents prepared by management adequately.¹⁴ The outcome of a rhetoric that advocated limiting liability had disastrous outcomes in the governance of healthy corporations that should not be replicated in the context of financially troubled corporations.

Further, it should be noted that trustees and receivers can limit the potential for successor employer liability in the bankruptcy context by seeking advance agreement from unions before making any key decisions. As Feldman J.A. noted in her reasons, it is in the unions' as well as the other corporate stakeholders' interests to reach a compromise given their mutual interest in the continuation of the business.

(b) The Bankruptcy Court's Gatekeeping Function and s. 215 of the BIA

The concern that receivers and trustees have with increased liability to employees when they operate a debtor corporation's business has the potential to be reduced by the bankruptcy court's supervisory role. This role involves both helping unions work with receivers and/or trustees to negotiate a compromise as to how employees will be treated, and rendering leave decisions under s. 215 of the BIA. That section provides that, "except by leave of the court, no action lies against the Superintendent, an official receiver, an interim receiver or a trustee with respect to any report made under, or any action taken pursuant to, this Act." Accordingly, the bankruptcy court is required to exercise a gatekeeping function and to screen any actions that third parties may wish to take

¹³ Poonam Puri & Stephanie Ben-Ishai, "Proportionate Liability Under the CBCA in the Context of Recent Corporate Governance Reform: Canadian Auditors in the Wrong Place at the Wrong Time?" (2003) 39 Can. Bus. L.J. 36.

¹⁴ *Ibid.*

against receivers and trustees, among others, and to grant leave in the appropriate circumstances. The rationale behind s. 215 is that “single control” is necessary in order for the bankruptcy court to address fairly and orderly the interests of every effected party and to avoid a multiplicity of proceedings.

(i) *Majority Reasons*

In her analysis of s. 215, Feldman J.A. noted that the test for leave has historically developed in the context of tort or fraud actions against a trustee where the test for leave was a low one. In that context, all that was required was a cause of action against the trustee and a factual foundation that was not frivolous or vexatious. A demonstration that the case could be made out was not required. In contrast, in the context of unions seeking leave to proceed to the OLRB for successor employer declarations, the actual substance of the leave test has not been developed. This is because where the issue arose in the past, leave was not granted on the basis that a collective agreement is a contract that terminates on bankruptcy. In rejecting this line of analysis, Feldman J.A. held that a collective agreement is not terminated for all purposes in bankruptcy and that the status of a collective agreement is governed by the LRA and the OLRB.

While Feldman J.A. rejected the line of analysis that suggests that a collective agreement terminates on bankruptcy, she did not adopt the s. 215 test that has been developed in other contexts, and would have suggested in this context that the bankruptcy court’s sole role was to determine whether there were facts that would allow the OLRB to declare the trustee or receiver a successor employer. Feldman J.A. held that unlike the situation where an action is brought against a trustee or a receiver for the ways in which their duties were carried out during a bankruptcy, in the context of a successor employer issue, the outcome of whether or not to grant leave is central to the bankruptcy or receivership as a whole. That is, the leave decision has implications for all stakeholders, including employees that need to be balanced by the bankruptcy court in making this decision. Accordingly, Feldman J.A. held that a bankruptcy court granting leave under s. 215 of the BIA must consider the following factors:

[T]he timing of the application, the complexity of the receivership and the demands on the receiver as it carries out its obligations, the potential duration of the

period that the receiver intends to operate the business before it can be sold (normally as brief as possible), the availability of potential purchasers and their financial strength, and the likelihood that a purchaser will be declared a successor employer and assume all of the obligations under the collective agreement. This latter factor may be particularly important because it will give practical assurance to the union that all the terms of the collective agreement will be honoured and the employees protected. Another key factor is the practicality of proceedings before the OLRB and the timeliness of a hearing before the tribunal in the context of the proposed temporary operation of the business and its sale. Finally, the court may consider the issue of immediate fairness to employees, including any arrangements that the receiver has made with the union to attempt to accommodate its requirements during the period before the business is sold.

(ii) *Dissenting and Concurring Reasons*

In dissent, MacPherson J.A. rejected Feldman J.A.'s test for granting leave to the OLRB for successor employer applications and instead adopted the test as articulated by Osborne J.A. in *Mancini (Trustee of) v. Falconi*¹⁵ at 334:

1. Leave to sue a trustee should be not granted if the action is frivolous or vexatious. Manifestly unmeritorious claims should not be permitted to proceed.
2. An action should not be allowed to proceed if the evidence filed in support of the motion, including the intended action as pleaded in draft form, does not disclose a cause of action against the trustee. The evidence typically will be presented by way of affidavit and must supply facts to support the claim sought to be asserted.
3. The court is not required to make final assessment of the merits of the claim before granting leave.

In adopting the *Mancini* test, MacPherson J.A. noted that Feldman J.A. was essentially allowing receivers and trustees to immunize themselves from the successor employer provisions by using s. 215 of the BIA, despite asserting that appointment orders under s. 47(2) of the BIA could not be used to do the same thing. MacPherson J.A. also expressed concern that the hurdles for employees and unions seeking leave under s. 215 appeared to be higher under the test articulated by Feldman J.A. as compared with the test that had been applied to creditors in the past. Cronk J.A. concurred with Feldman J.A.'s reasons and suggested that in future s. 215 decisions, the higher standard for leave applications will

¹⁵ (1993), 1993 CarswellOnt 1861, (sub nom. *Mancini (Bankrupt) v. Falconi*) 61 O.A.C. 332 (Ont. C.A.).

apply in situations not related to successor employer provisions, and accordingly, will not present a higher hurdle for employees and unions as is suggested by MacPherson J.A.

(iii) *Commentary*

MacPherson J.A. raises a valid concern with respect to the different standards that will apply to different stakeholders seeking leave under s. 215 of the BIA. Feldman J.A. distinguishes between a situation such as *Mancini*, where the issue was trustee wrongdoing, and a situation where factors relating to the bankruptcy court's control over the bankruptcy process arise. It would have been helpful for Feldman J.A. to have elaborated on a framework for distinguishing between the situations when the *Mancini* standard for leave will apply and the situations when the newly formulated standard will apply outside of the successor employer and OLRB contexts. Given that the *Mancini* test has been applied to creditors in the past, the majority reasons do suggest a hierarchy between creditor stakeholders and other stakeholders, as MacPherson J.A. notes. However, given Feldman J.A.'s careful analysis throughout the reasons in *TCT* of the multiple stakeholders who have interests that must be balanced in bankruptcy, it does not appear that it was her intent to create such a hierarchy. A statement in future jurisprudence to the effect that the nature of the s. 215 test turns on whether granting leave will take away from the existence of a central controlling forum and not on the identity of the stakeholder who brings such an application would help to clarify this issue.

With respect to the second point of disagreement between the majority and the dissent, it is important to note the difference between the role of the receiver and/or trustee and the bankruptcy court. In focusing on this distinction, it becomes clear that Feldman J.A. was not using s. 215 to enable what she rejected under s. 47. Court-appointed receivers and trustees play a central role in the effective implementation of bankruptcy law in Canada. As court-appointed officers they have an obligation to ensure that bankruptcy laws are applied effectively and impartially. Given their access to detailed information surrounding the corporation and its affairs, they are also in the best position to make informed decisions. However, receivers and trustees are not a substitute for the bankruptcy court.

Due process in bankruptcy proceedings requires that a court of competent jurisdiction adjudicate a dispute between a receiver or a trustee and an interested party. Given that bankruptcy is a legal process, there are important limits on how much the court's role can be diminished. The majority reasons in *TCT* limit the amount of authority without liability that can be conferred on receivers and trustees by parties who use s. 47(2) of the BIA to ask the bankruptcy court to "rubber-stamp" private agreements that immunize them from liability to third parties. At the same time, the majority reasons recognize that at times the careful balancing act that is necessary to liquidate a corporation with the least impact on third parties could be severely disrupted by a multiplicity of proceedings related to the bankruptcy process in other forums. It is within this context that Feldman J.A. has provided an orderly process for ensuring that stakeholders, unions in this case, can be given an opportunity to appear before a bankruptcy court if they feel that their rights have not been adequately protected in the private decisions made by the receiver or trustee, the debtor corporation, and major creditors in the negotiation process. The s. 215 test articulated by the majority, with a clarification that its application does not turn on the identity of the stakeholder who brings the application, is well suited to the delicate balancing act that takes place in the corporate bankruptcy context.

4. CONCLUSION

The Court of Appeal's decision in *TCT* has disturbed the status quo understanding of receiverships where private parties, irrespective of the rights of third parties, can agree upon the terms and have them rubber stamped *ex parte* by the bankruptcy court. Instead, the Court of Appeal has given greater "teeth" to the bankruptcy court's gatekeeping function. However, the s. 215 test articulated by Feldman J.A. will only be effective if the Canadian judiciary has sufficient capacity to implement it.

Given this renewed emphasis on the role of the judiciary in the Canadian bankruptcy system, it will be important to develop a better understanding of which members of the Canadian judiciary are handling bankruptcy cases and how. In addition, *TCT* provides an opportunity to give careful thought to the creation of social context education¹⁶ specif-

¹⁶ See Richard F. Devlin, "Jurisprudence for Judges: Why Legal Theory Matters for

ically designed for bankruptcy judges. It is true, as Feldman J.A. notes in her reasons, that qualities of a good bankruptcy judge include expertise, sensitivity and speed. However, equally important qualities for bankruptcy judges include the ability to understand the impact of social, economic, cultural, and political forces on the issues and corporate stakeholders that appear before them. The diversity of these contexts is often hidden from view when the same group of bankruptcy practitioners and judges with shared socio-economic backgrounds, gender, and race, repeatedly appear in Canadian bankruptcy courts. In addition to implementing some form of social context education, it will be important to encourage the development of a new generation of bankruptcy practitioners and members of the judiciary who are able to contribute the diverse perspectives and life experiences of employees and other stakeholders in the bankruptcy process, while at the same bringing the necessary expertise and integrity to this legal process.

Social Context Education” (2001) 27 Queen’s L.J. 161, for a further discussion of this concept.