THE COLLAPSE AND REHABILITATION OF THE $32 BILLION CANADIAN ASSET BASED COMMERCIAL PAPER MARKET

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The week of August 13, 2007 was an eventful week in Canadian financial markets. This was the week that the $32 Billion Canadian market for third party Asset Backed Commercial Paper ("ABCP") experienced an overnight, sudden and complete seizure. It would take many painful months of difficult negotiations led by a committee of the principal holders of the ABCP before this crisis found a resolution in a plan of compromise which was given effect to under Canada's *Companies' Creditors Arrangement Act* (the "CCAA").

This paper will first review briefly the risks faced by the Canadian ABCP market and the key players in that market leading up to the meltdown in August of 2007. It will then outline the challenges faced and the resolutions reached in the restructuring of that market. This paper will also illustrate the utility provided by the CCAA, without which such a complex restructuring would not have been possible.

The CCAA Scheme

The CCAA came into existence in 1933 and was, and still is, a very short piece of legislation with minimal detail. The CCAA essentially allows an insolvent debtor company the means by which to avoid bankruptcy or liquidation with a view to restructuring its rights and obligations to its various stakeholders. Under the protection of a broad stay of proceedings, a debtor company can negotiate compromises or arrangements with its creditors and other stakeholders and incorporate those compromises and arrangements into a plan (the "Plan"). The ultimate goal of the Plan is generally to allow the debtor company to emerge from insolvency as a going concern. The Plan must be approved by the debtor company's creditors. For this purpose, those creditors are divided into classes based upon a commonality of interests. The creditors' votes on the Plan will then be tabulated on a class-by-class basis and the Plan must be approved by a majority of the creditors voting in each class, which majority of creditors must also account for at least 66⅔% of the value of the indebtedness owing to creditors in that class. Following creditor approval, the Plan must be approved by the court as fair and reasonable.

ABCP: The Framework and Key Players in Canada

In the course of dealing with this case, Justice Blair of the Ontario Court of Appeal provided a concise description of the ABCP landscape, reproduced below as a useful roadmap for the discussion to be provided in this paper:

> "As I understand it, prior to August 2007 when it was frozen, the ABCP market worked as follows.
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> Various corporations (the "Sponsors") would arrange for entities they control ("Conduits") to make ABCP Notes available to be sold to investors through "Dealers" (banks and other investment dealers).

> Typically, ABCP was issued by series and sometimes by classes within a series.
>
> The cash from the purchase of the ABCP Notes was used to purchase assets which were held by trustees of the Conduits ("Issuer Trustees") and which stood as security for repayment of the notes. Financial institutions that sold or provided the Conduits with the assets that secured the ABCP are known as "Asset Providers". To help ensure that investors would be able to redeem their notes, "Liquidity Providers" agreed to provide funds that could be drawn upon to meet the demands of maturing ABCP Notes in certain circumstances. Most Asset Providers were also Liquidity Providers. Many of these banks and financial institutions were also holders of ABCP Notes ("Noteholders"). The Asset and Liquidity Providers held a first charge on the assets.
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> When the market was working well, cash from the purchase of new ABCP Notes was also used to pay off maturing ABCP Notes; alternatively, Noteholders simply rolled their maturing notes over into new ones."

From the above description, one can see that the ABCP market was comprised of a very complex group of stakeholders, many of whom played multiple roles. Some of the Asset Providers were also Liquidity Providers, holders of ABCP Notes and Dealers or affiliates of Dealers.

Overall, $116 Billion had been invested in the Canadian ABCP market. The $32 Billion portion of the market that was restructured represented the portion of the market for which banks did not act as Conduits. Whereas Conduits that were bank controlled had continued access to liquidity throughout the crisis, the non-bank Conduits ran out of cash almost immediately, once the paper stopped revolving and the provision of cash by the Liquidity Providers was denied. Among the holders of ABCP Notes that were affected approximately 1800 were retail investors and 17 were financial and investment institutions.

The Breakdown of the ABCP Market

The cause of the breakdown in the ABCP market can be attributed to three main factors. First was a mismatch between the terms of the ABCP Notes and the underlying asset collateral provided by Asset Providers. Second was the substantial investor panic over the value of the asset collateral provided by Asset Providers. Third was the failure of Liquidity Providers to provide liquidity as anticipated.

A fundamental issue in the ABCP market was the mismatch between the term of the ABCP Notes and the term of the asset collateral held in the Conduits and provided by the Asset Providers. Unlike the ABCP Notes, the asset collateral was not of a short-term nature. Much of the asset collateral was comprised of residential mortgages, credit card receivables or credit default swaps. The cash flow generated by longer term assets of this nature did not match the cash flow required to repay maturing ABCP Notes. Notwithstanding such mismatches, most holders of ABCP Notes were prepared to reinvest in new ABCP Notes at maturity. In addition to this, ABCP Notes continued to be sold and the proceeds thereof used to repay existing ABCP Notes. The combination of these two

activities, purported to ensure that the market continued to function as anticipated. In addition to these factors, the existence of Liquidity Providers provided an additional, but insufficient, layer of comfort.

Investor psychology, rational or not, played a huge role in the collapse of the ABCP market. Market sentiment and the alarming rate of defaults on US sub-prime mortgage portfolios unquestionably caused investors in ABCP Notes concern about the value of the asset collateral held in the Conduits. Investor concerns focused on the lack of understanding of what made up the asset collateral supporting the ABCP and how much of any particular portfolio of asset collateral was comprised of US sub-prime mortgages. As a result of what has been characterized as a lack of transparency, current ABCP investors refused to roll their ABCP Notes at maturity and new investors were unwilling to purchase ABCP Notes at the prices traditionally paid for such notes. The first set of safeguards that were said to remedy the mismatch problem outlined above were eliminated.

The Liquidity Providers, said to be an important line of defence for the ABCP market in the event that the liquidity expected from purchases and rollovers of ABCP Notes did not materialize, did not end up providing much needed liquidity for the ABCP market. The Liquidity Providers were reluctant to sink additional funds into the apparently failing ABCP market and they had a possible means of escape from doing so. Under the terms of many contracts for liquidity provision, a Liquidity Provider was only obligated to fund if there had been a "market disruption". Needless to say, it quickly became a heated dispute as to whether the events of August, 2007 constituted a "market disruption". Liquidity Providers took the position that no market disruption had occurred based in part on the fact that only the third-party, and not the bank-sponsored ABCP market had been affected by the above concerns.

A debate will persist on whether or not the Liquidity Providers could have provided sufficient investor confidence in the Canadian ABCP market had they all agreed to provide much need liquidity. It is possible that this vote of confidence from the Liquidity Providers may have encouraged investors to continue purchase ABCP Notes, thus saving the then existing ABCP market in Canada at a relatively low cost.

Regardless of who was to blame, as of mid-August in 2007, it became clear that the Canadian ABCP market faced an immediate liquidity crisis.

The Immediate Response of Holders of ABCP Notes

The response to the crisis among the largest ABCP Noteholders was rapid and quite decisive. Meetings were arranged on an expedited basis with a view to seeking interim arrangements whereby the market participants could work together in good faith to implement a comprehensive restructuring of outstanding ABCP. This resulted in a series of consensual standstill periods to enable the parties to discuss more comprehensive arrangements to avert a complete financial disaster for most market participants and intermediaries. At this point, the vast majority of individual ABCP Noteholders were not engaged in the process.

A committee was formed, comprising representatives of various stakeholder groups, with the view to maximizing recoveries as "efficiently and fairly" as possible in the "best interests of stakeholders". The committee convened its first formal meetings in September of 2007 and worked diligently throughout this process.

The daunting prospect of re-engineering the underlying financial assets of the ABCP market was equalled by the challenges to be faced in identifying what, if any, process could be utilized to facilitate a comprehensive restructuring of an entire market rather than just an insolvent company. The process identified by the participants was a court supervised proceeding under the CCAA, the primary restructuring statute for large insolvent companies in Canada.

Threshold Issues under the CCAA

As will be seen throughout this paper, without the mechanisms provided by the CCAA, it is unlikely that the ABCP market restructuring could have been brought to as beneficial a conclusion for all stakeholders. That statute, which contained a mere 21 sections at the time of the ABCP restructuring, is a framework that exhibits both the simplicity and flexibility necessary to allow stakeholders and a court to engage in the task of restructuring an entire financial market. In attempting to utilize the CCAA, the participants in the ABCP restructuring process faced a number of technical or legal hurdles.

The CCAA only applies to an entity that can be defined as a "debtor company". This created two primary obstacles for the restructuring of the ABCP market. First, many of the Issuer Trustees were trust companies. These specifically do not qualify as "companies" and cannot be "debtor companies". Second, to be entitled to relief under the CCAA, a "company" must be insolvent. The determination of insolvency was not as straightforward as it might first appear. Each trustee was responsible for liabilities under the trust indenture to the extent of the assets available to it under the trust. In other words, the extent of the insolvency was limited by the value of the underlying assets in the trust.

Qualifying the Issuer Trustees as "companies" for the purposes of the CCAA was not particularly problematic. This simply required the replacement of the ineligible Issuer Trustee with a newly incorporated Issuer Trustee that was an eligible "company". While this was a technical change made specifically for the purpose of gaining access to the CCAA, the Court agreed that this usage of a technical device was acceptable.

Arguing that the Issuer Trustees were insolvent was also fairly simply dealt with. The converted Issuer Trustees argued that they would meet the definition of an insolvent debtor company as they were unable to meet liabilities as they fell due since they could not repay ABCP Notes at maturity. It was not necessary to consider the fact that the trustee was not liable for a deficiency.

Once the above threshold issues were handled, the door was open for the restructuring in respect of the Issuer Trustees of 20 Conduits and 47 series of ABCP Notes within one cohesive proceeding. Retaining control of the entire process within one proceeding was essential to the practical and efficient restructuring of the market as a whole. By pursuing a single CCAA proceeding, holders of various series of ABCP Notes would be dealt with on a global basis through various means which attempted to preserve the underlying value of that series but did so without recognising the distinctiveness of each series or Conduit.

The Plan

Immediately upon filing for protection under the CCAA on March 17, 2008, the committee sought court approval for a comprehensive restructuring of the $32 billion third-party ABCP market

(the "Plan"). That restructuring plan had been negotiated over the months leading up to the filing for protection.

As a preliminary matter a stay of proceedings was imposed that intended to restrain proceedings against the debtor companies and other non-debtor companies that were participants in the ABCP market. The necessity of such expansive relief was made apparent by the interconnectedness of the market as a whole. If suits were permitted to be commenced against even new-debtor companies, the resulting chaos would undermine the court's ability to implement a restructuring proceeding. The power to grant such broad stays of proceedings is found in the discretion provided to the court in drafting its initial order in any CCAA proceeding.

One exceptional feature of this particular filing was the fact that a plan was filed contemporaneously with protection being sought under the CCAA. This is not usually the case. However, in this matter, discussions and negotiations had been underway since September of 2007. Working under the various standstill arrangements adhered to by the parties throughout, those parties had a considerable period of time to formulate a plan. Accordingly, the court was told that the plan was in its final stages and not subject to substantial amendment. This was due to the sheer complexity and volume of issues requiring the attention of the parties, and the disparate risks associated with each constituent's position. It is very important to note that the banks and asset providers who made up the substantial bulk of the so-called secured creditors in this proceeding, were themselves exposed to market risk throughout, but nevertheless continued to support the process in an effort to rehabilitate the market as a whole. Their cooperation, however, was never taken for granted since the Asset Providers themselves were in constant re-evaluation of their position vis-à-vis the market. Moreover, there was no legal means to compel the Asset Providers to participate in this proceeding since the nature of their contractual relationship to the market rendered them immune from any stays of proceedings which could have been effected under the CCAA.

The committee was adamant that all affected ABCP Notes suffered from common problems, regardless of their series or the Conduit through which they were issued and that the Plan took into account the commonality of problems while respecting the value contributed by a particular series of ABCP Notes. As a result, the Plan contemplated one creditor class for voting purposes, thus increasing the chances that it would be approved by the requisite majority of creditors.

The heart of the Plan was the exchange of the original ABCP Notes for new restructured ABCP Notes. The Plan contemplated the creation of three asset pools, each reflecting, in part, the nature and value of the underlying collateral assets contributed by the Issuer Trustees to each asset pool The restructured ABCP Notes would be issued to the holders of each series of the original ABCP Notes at a value tracking the value of the underlying assets in the pool to which such restructured ABCP Notes were attributable. In this way, despite the administrative consolidation of the Conduits, the holders of the original ABCP Notes would not be deprived of the value supporting their original ABCP Notes.

The restructured ABCP Notes would be issued at, and would likely trade at, a discount compared to the stated principal value of the original ABCP Notes. This was the compromise that ABCP Noteholders would have to agree to in order to make this restructuring viable.

The terms of the restructured ABCP Notes would address each of the following deficiencies:

- A lack of transparency in the nature and value of the asset collateral held by the Issuer Trustees;

- Mismatched cash flow issues between the ABCP Notes and the underlying asset collateral; and
- Unworkable default triggers.

The lack of transparency that existed with respect to the underlying asset collateral was remedied by increased disclosure requirements to the holders of the ABCP Notes.

The mismatched cash flow issues inherent in the original ABCP Notes would be mitigated by adjusting the maturities and interest rates of the restructured ABCP Notes to match the timing and nature of returns from the underlying collateral asset pools.

At the same time as all of the above, holders of ABCP Notes would receive the benefits of relaxed margin triggers, and participants would receive access to margin funding on very favourable terms. This move increased the market risk to Asset Providers. As a consequence, the Asset Providers required more security to mitigate that additional risk to them. This risk mitigation was accomplished in two ways. First, two of the newly created asset pools would cross-collateralize each other, thereby making assets available to the Asset Providers which were not originally available. Second, margin funding facilities would be required.

In return for the various contributions of the Asset Providers, the Asset Providers required comprehensive releases of virtually all key participants in the ABCP market, including the original Issuer Trustees, the Conduits, the new Issuer Trustees, the Liquidity Providers, the Dealers, the various Canadian financial institutions involved in the restructuring and DBRS Limited. Not surprisingly, the other participants in the Plan sought similar comprehensive releases and the Plan evolved such that substantially all participants were comprehensively releasing each other.

Impediments to Approval of the Plan

The two primary issues that the court had to resolve in granting the relief requested under the plan were: (a) whether all holders of the ABCP Notes should be grouped in a single class; and (b) whether or not releases requested were permissible under the CCAA or within the jurisdiction of the court to grant.

The matter of classification became somewhat moot for the following reason. The monitor in the CCAA proceedings had the capacity to assemble information on voting results on a series by series basis. Voting under a particular Conduit could be tabulated for the purposes of assessing whether or not the Plan would have passed on a segregated or consolidated basis, as the case may be. As it happened, voting was overwhelmingly in favour of plan approval on virtually any tabulation or permutation of votes. In addition, objecting creditors also wished to separate those votes of committee members and others who they deemed insiders for the purposes of the vote from those noteholders who they described as "pure note holders". Even on this calculation, the vote was overwhelmingly favourable to the plan.

The releases sought by the Asset Providers, and the various releases sought by all of the other participants were the most hotly contested component of the Plan. These releases were comprehensive and were to be available in favour of all debtor and non-debtor parties. In essence, the releases would have impacted the rights of noteholders against, for example, Dealers who may have sold ABCP Notes under questionable circumstances. As originally formulated, the releases contained no exception for

fraud or wilful misconduct. However, the releases were eventually amended to provide for a carve-out for fraudulent misrepresentations as defined in the amended Plan.

The matter of the releases was considered both by the Application Judge and by the Ontario Court of Appeal.

The opponents to the broad and comprehensive releases were primarily the holders of the ABCP Notes, who would intend to bring actions against the Dealers for any deficiency that such ABCP Noteholders experienced under the Plan. Because many of the Dealers were also affiliated with the Asset Providers and Liquidity Providers, whose support was integral to the Plan's success, these objections from the Noteholders were a significant threat to the viability of the Plan. From a legal perspective, the objections to the releases were essentially, first, that the releases would compromise the rights of the noteholders with respect to claims against parties, such as Dealers, that were not debtors and, as such, those rights should not be compromised by a CCAA Plan, and, second, that the releases were neither fair nor reasonable due to their excessive scope.

The Application Judge accepted the releases as a valid part of the Plan, but not before compelling the parties to undertake an investigation as to the types and values of claims that may be compromised by the releases. This decision was appealed.

In evaluating its jurisdiction to approve the releases, the Ontario Court of Appeal took the view that the very title of the CCAA states that it is: an Act to facilitate compromises and arrangements between an insolvent debtor company and its creditors. Clearly, the releases help to facilitate such a compromise and arrangement. The court then quoted from a decision of the British Columbia Court of Appeal, which articulated the purpose, object and scheme of the Act:

> Almost inevitably, liquidation destroyed the shareholders' investment, yielded little by way of recovery to the creditors and exacerbated the social evil of devastating levels of unemployment. The government of the day sought, through the CCAA, to create a regime whereby the principals of the company and the creditors could be brought together under the supervision of the court to attempt the reorganization or compromise or arrangement under which the company could continue in business.[1]

The Ontario Court of Appeal specifically rejected the position of the opponents of the Plan that the CCAA has no application to the restructuring of entire marketplaces, which may involve granting their party releases.[2]

The court then explained the broad purposes of "compromise" and "arrangement" to which the CCAA could be put:

> "The CCAA is a sketch, an outline, a supporting framework for the resolution of corporate insolvencies in the public interest. Parliament wisely avoided attempting to anticipate the myriad of business deals to be

[1] *Chef Ready* 4 C.B.R. (3d) (BCCA) 311 at 318 per: Gibbs J.A.

[2] *Metcalfe* at para 55.

> worked and within the framework of the comprehensive and flexible concepts of a "compromise" and "arrangement." I see no reason why a release in favour of a third party, negotiated as part of a package between a debtor and a creditor and reasonably relating to the restructuring cannot fall within that framework."[3]

The court then went on to explain that a plan of compromise and arrangement under the CCAA is directly analogous to a contract between a debtor and its creditors.[4]

The court did curb to some degree the availability of third-party releases. The court was willing to sanction the Plan, along with the third-party releases contained therein, as long as:

(a) the parties to be released were necessary and essential to the restructuring of the debtor;

(b) the claims to be released were rationally related to the purpose of the Plan and necessary for it;

(c) the Plan could not 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 the holders of the ABCP Notes generally.[5]

All of the above requirements were met in the case of the ABCP restructuring. All of the released parties, even the Dealers, were integral to the ABCP market, and their participation in that market following the implementation of the restructuring plan was essential. Further, any claims that arose in connection with the sale or distribution of the ABCP Notes, which claims were the subject of the releases, were clearly rationally related to the Plan. As the court explained, "It may be true that in their capacities as ABCP dealers, the releasee financial institutions are "third parties" to the restructuring in the sense that they are not creditors of the debtor corporations. However, in their capacities as Asset Providers and Liquidity Providers, they are not only creditors but they are prior secured creditors to the Noteholders."[6] This comment highlights the interconnected nature of the various participants in the ABCP market and the court's recognition of the fact that the support of the Asset Providers and the Liquidity Providers was essential to the Plan.

The scope of the releases was also dealt with by the court. The court explained that it must be satisfied that the voting creditors who approved the Plan did so with knowledge of the nature and effect of the releases, and also that the scope of the releases must be must be fair and reasonable and not

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[3] *Metcalfe* at para 61.

[4] *Metcalfe* at para. 62.

[5] *Metcalfe* at paras. 70 - 73

[6] *Metcalfe* at para 55.

overly broad or offensive to public policy.[7] The releases sought in the Plan were fair and reasonable, particularly since they did not extend to releases of all claims of fraud or wilful misfeasance.

Lessons and Conclusions from the Canadian ABCP Experience

Canada's ABCP experience was quite unique. It was a private solution to a problem that was only solved in other jurisdictions with extremely extensive government guarantees, liquidity provision, and other forms of government intervention. The two key points that can be drawn from the above experience are: first, that there is extreme utility in a simple and broadly drafted restructuring statute such as the CCAA; and second, that the value of a proactive set of stakeholders in a restructuring process cannot be minimized.

As explained at the outset of this paper, the restructuring of the ABCP market would likely not have been possible without a minimalist statute, such as the CCAA that offered the court great discretion. There were simply too many moving parts to fit neatly within the confines of a more rigid statute. The controversy over the third-party releases, which were an essential element of the Plan, illustrates this point. The Ontario Court of Appeal highlighted two key factors that facilitated the development and eventual approval of the Plan in the ABCP matter: (a) the skeletal nature of the CCAA; and (b) Parliament's reliance upon broad notions of "compromise" and "arrangement" to establish the framework within which the parties may work to put forward a restructuring plan.[8]

A minimalist statute, of course, is only as valuable as the expertise of the court that has the role of interpreting it. Both the Application Judge and the Ontario Court of Appeal performed highly detailed analyses not only of the law, but also of the practical realities of the Canadian ABCP market. The practical detail of this analysis can certainly be partially credited to the expertise developed in Commercial List section of the Ontario Superior Court of Justice, where the Application Judge heard this matter. The Commercial List section is devoted exclusively to matters of a commercial nature, primarily insolvency related matters. Thus, the Application Judge in the ABCP matter was able to develop an extensive understanding of the practical realities of insolvency matters generally, which would have been utilized in the ABCP context.

The proactive role of the committee of participants in the ABCP market that both realized the severity of the issue that the market faced in August of 2007 and acted quickly to limit the damage caused thereby must also be highlighted. Any major creditor in the Canadian ABCP market could have scuttled the restructuring endeavour by attempting to enforce its rights unilaterally. It was not until March of 2008 that a court ordered stay of proceedings was put in place to ensure that this did not happen. Great effort was made, however, to ensure that all necessary parties were engaged in the process and each of the key participants in the ABCP market understood and agreed that restructuring was the best option and worked diligently toward that goal. Having said all of the above, it is important to note that the alternative to a successful restructuring in the ABCP market (being a total and permanent collapse of that market) was so bleak that rational actors had sufficient incentive to diligently pursue the restructuring.

The ABCP matter is extremely useful going forward as it provided a very high profile forum to test the boundaries of Canada's primary restructuring statute. For restructuring professionals, it has

[7] *Metcalfe* at para. 113.

[8] *Metcalfe* at para. 58.

solidified the proposition that a court supervised restructuring is essentially a means by which debtors, creditors and other relevant stakeholders can enter into a mutually beneficial agreement in respect of their interests so long as all of those interests have a sufficient nexus to the successful restructuring of the debtor company. This is not to suggest that the court will simply rubber stamp any deal that the parties have negotiated in formulating a Plan. The court will still carefully evaluate whether such deal is fair and reasonable in the circumstances.

Ogilvy Renault LLP acted for the largest ABCP holder in this matter.

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