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• QUALIFYING THE MONITOR'S INDEPENDENCE •

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LEASE DEPOSIT CHARACTERIZED AS SECURITY INTEREST: SUMMARY OF *ALIGNVEST PRIVATE DEBT LTD. v. SUREFIRE INDUSTRIES LTD.*

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Since the re-emergence of the use of the *Companies' Creditors Arrangement Act* [*CCAA*][1] in the 1980s, there has been an evolution in the role and qualification of the monitor. In the 1980s, there was no statutory requirement for the appointment of a monitor in a *CCAA* proceeding, nor was it stipulated what qualifications were necessary to act as monitor. It had been commonplace for a debtor's auditor to act as monitor. A series of amendments to the *CCAA* has resulted in, among other requirements, the requirement for a monitor to be appointed in a *CCAA* proceeding and for that monitor to be a licensed trustee in bankruptcy. The amendments also prohibit a debtor's auditor from acting as the monitor due to concerns about the monitor's independence.

This article discusses the recent and unique decision rendered by the Honourable Justice Newbould to replace the monitor that had been appointed in the initial order granted in the *Nelson Education Ltd. (Re) CCAA* proceeding [*Nelson*].[2]

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Background

Nelson distributes education materials to schools and other institutions throughout Canada. Nelson was the Canadian portion of a US$7.75 billion purchase in 2007. Cengage Learning ("Cengage") was the U.S. portion of the purchase. The assets attributed to Nelson were valued at US$550 million. The financing of the Nelson portion of the purchase included US$311.5 million from first lien lenders ("FLL") and US$171.3 million from second lien lenders ("SLL").

Nelson's profitability suffered because of print-to-digital media trends and a general industry decline. As a result, EBITDA declined from $47.4 million to $40.9 million between 2011 and 2013.

In March 2013, Nelson retained Alvarez & Marsal Canada Inc. ("A&M") as its financial advisor ("FA") to provide restructuring advice. Also in 2013, a U.S. affiliate of A&M was engaged to provide financial advisory services to Cengage. Nelson was the exclusive distributor for Cengage content in Canada; Cengage also provided operational support to Nelson.

The FA considered Nelson's attributes, including its historical financial results, capital structure, and business prospects. Together with Nelson, the FA developed and implemented a sale and investor solicitation process in September 2014. At the conclusion of the process, there were no acceptable bids. In conjunction with the FLL, a credit bid for Nelson's business and assets was structured. The prospective purchaser, which would be owned by the FLL, would acquire all of Nelson's assets and assume all of its obligations, except those to the SLL and certain other creditors.

In May 2015, Nelson applied for and was granted protection under the *CCAA* and sought court approval on an expedited basis to effect the credit bid sale. The FA was appointed monitor under the initial order. Due to opposition from Royal Bank of Canada ("RBC"), who was a member of both the FLL and the SLL, with respect to the process leading up to the filing and the timeline for approval of the transaction, the initial order was amended so as to be scaled down, and the court set a date for a "true" comeback hearing at which to hear RBC's concerns. The comeback hearing was contested—RBC sought to, among other things, replace the monitor.

Decision

Justice Newbould considered the arguments and ultimately sided with RBC. The crux of His Honour's reasoning can be found in paras. 36 to 39 of the decision, including the following:

> In this case, A&M is in no position to comment independently on the activities of Nelson in regards to the very issue in this case, namely the reliability of the SISP program in determining whether the second lien lenders' security has any value.
>
> There is also a question of the appearance of a lack of impartiality. During the two years A&M was engaged prior to this CCAA proceeding, for which it billed over $5 million, it was involved in advising Nelson during negotiations with the interested parties, including RBC, and in participating in those negotiations with RBC on behalf of Nelson. This history can cause an appearance of impartiality, something to be avoided in order to provide public confidence that the insolvency system is impartial. See *Winalta* at para. 82. It was this concern of a perception of bias that led to the prohibition being added to section 11.7(2) of the CCAA preventing an auditor of a company acting as a monitor of the company.

Justice Newbould then sought to distinguish Nelson from other potentially similar situations:

> The issue of an appropriate monitor requires the balancing of interests. This is not like some cases in which a financial advisor has had some advisory role with the debtor and then becomes a monitor; usually with no objection being raised. Often it may be appropriate for that to occur taken the knowledge of the debtor acquired by the advisor. This case is different in that the financial advisor has been front row and centre in the very sales process that will be the subject of debate in these proceedings and has engaged in negotiations on behalf of Nelson.[3]

Discussion

One of the main issues the court had to consider was whether it is appropriate for a firm ("Advisory Firm") to develop and run a sale process prior to the *CCAA* proceeding and then act as monitor, being an officer of the court, and provide an opinion on the transaction resulting from that process. A secondary issue was whether the transaction should proceed as a *quick flip*.

It is common for the Advisory Firm being nominated as *CCAA* monitor (or receiver) to have a pre-existing relationship with the debtor or one of its senior stakeholders. The pre-filing relationship allows the Advisory Firm to obtain essential financial and operational information about the debtor, which enables the Advisory Firm to assist the debtor in developing financial plans and restructuring strategy options. In some cases the Advisory Firm will assist the debtor in efforts to find a resolution of its challenges that avoids an insolvency filing, with an insolvency filing being something of a last resort. In other cases, the Advisory Firm is essentially engaged to assist the debtor in preparing for and commencing an insolvency proceeding. Among the strategies that regularly develop are downsizing, divesting of non-core business divisions, selling all or part of the business, or liquidating its assets. It is common for the Advisory Firm to assist in developing and running a sales process, knowing that a purchaser may ultimately require that the transaction be completed pursuant to an insolvency proceeding. These activities are normal and assist in the efficient transition of a business to new owners.

In carrying out its activities, the Advisory Firm, being the prospective court officer, is mindful that the steps taken will be used as evidence when or if court approval is sought for a particular transaction. The Advisory Firm is mindful of its prospective future role and duties, and the scrutiny that will be brought to bear on its pre-appointment activities. Essentially, the Advisory Firm morphs into the court officer on the commencement of the ensuing insolvency proceeding and often makes stakeholders aware that it would be doing so, either in its engagement letter or in other communications. It is customary to make clear in engagement letters that once appointed as a court officer, the Advisory Firm does not work for or take instructions from the debtor company. As a continuation of the disclosure theme, the Advisory Firm describes the full history of its involvement with the debtor in its initial report to the court. This maintains the integrity and transparency of the process.

In *Nelson*, there were a few facts that appear to have troubled the court:

1. the duration of the FA's pre-filing relationship with Nelson, being over two years
2. the scope of the involvement by the FA with the management and board of Nelson
3. certain individuals at A&M having worked on both the FA role and the Monitor role
4. the fees that the FA earned over the period of its mandates with Nelson
5. the FA's interaction with the SLL

Justice Newbould determined that the FA was not in a position to comment independently on the sales process that Nelson was seeking to have approved by the court and there was an appearance of lack of impartiality of the FA. As a result, Newbould J. concluded that it would be preferable to replace the FA as the monitor—the first time a court has ordered that a *CCAA* monitor be replaced.

Case Comparison

Nelson is not an outlier. The factual matrix in *Nelson* is similar to many circumstances where court approval of a transaction is sought on or very shortly after the commencement of formal proceedings. In virtually all of those situations, the advisor to the debtor, the secured lender, or both have been involved for an extended period, have run or at least overseen the sale process, describe and opine on the pre-filing process.

Tool-Plas Systems Inc., Re,[4] a leading case on quick flips with the Advisory Firm becoming the court-appointed officer (a receiver, in that case), is a good example. Tool-Plas was a supplier of moulds and dies to suppliers in the automotive industry. The Advisory Firm carried out many of the same activities as A&M: it evaluated the viability of the debtor's business, prepared financial models, negotiated with the debtor's four secured creditors, carried out a sale process, and negotiated a transaction that provided for the purchaser to assume the senior secured debt. After an agreement had been executed, Tool-Plas brought a motion for the court to appoint the Advisory Firm as receiver, and on the same day, the receiver brought a motion for approval of the transaction.

Justice Morawetz (as he was then) made the following observations:

> The Receiver is also of the view that the proposed purchase price exceeds both a going concern and a liquidation value of the assets. The Receiver has also obtained favourable security opinions with respect to the security held by the Secured Lenders. Not all secured creditors are being paid. There are subordinate secured creditors consisting of private arms-length investors who have agreed to forego payment.
>
> […]
>
> A 'quick flip' transaction is not the usual transaction. In certain circumstances, however, it may be the best, or the only, alternative. In considering whether to approve a 'quick flip' transaction, the Court should consider the impact on various parties and assess whether their respective positions and the proposed treatment that they will receive in the 'quick flip' transaction would realistically be any different if an extended sales process were followed.
>
> I am satisfied that, having considered the positions of the above-mentioned parties, the proposed sale is reasonable. I accept the view of the Receiver that there is a risk if there is a delay in the process. I am also satisfied that the sale price exceeds the going concern and the liquidation value of the assets and that, on balance, the proposed transaction is in the best interests of the stakeholders.
>
> I am also mindful that the Secured Lenders have supported the proposed transaction and that the subordinated secured lenders are not objecting.[5]

In approving the transaction, Morawetz J. accepted that the principles in *Royal Bank of Canada v. Soundair Corp.* [*Soundair*][6] had been followed, notwithstanding that the process had been run before the filing.

So, is that different from *Nelson*? Yes, maybe:

1. Urgency was established in the *Tool-Plas* matter. There was a risk that the business would be prejudiced if the transaction was not approved on an expedited basis. The materials in *Nelson* do not address similar concerns.
2. The secured creditors in *Tool-Plas* either consented to or did not oppose the relief sought by the Receiver. In *Nelson*, the second lien lenders opposed the Monitor's appointment and approval of the transaction.

Should it matter to the selection of the court's officer? In our respectful view, *no*. The key issue is the integrity of the process, not timing of its approval or the positions of the secured creditors. Involving another financial services firm to conduct a second sale process or opine on the process run by another party pre-filing is not an effective solution. Conducting a post-filing process may be duplicative, adding costs, and creating delay—neither of which is helpful to the business. There is no assurance that the process or its outcome will be any different. It also does not change the core issue that the court in *Nelson* struggled with at first instance; the Monitor will be commenting on the process it runs.[7] The optics may be better, but optics is often an issue with our system, and we have learned that substance and efficiency should trump that concern.

Further Musings

While the decision includes qualifiers to avoid it becoming the new precedent dealing with the appointment of a monitor, one wonders if it will be used nonetheless when an "out of the money" stakeholder seeks another kick at the can. One also wonders what the result would have been had Nelson and/or the Monitor sought approval of a post-filing sale process, expedited or otherwise, with the credit bid acting as a stalking horse. Doing so would, arguably, have addressed concerns vis-à-vis the integrity of the sale process and avoided the necessity to bring two new professional firms (*i.e.*, a new Monitor and new counsel to the Monitor) into the proceedings, with the attendant costs.

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[1] *CCAA*, R.S.C. 1985, c. C-36.

[2] *Nelson*, 2015] O.J. No. 2859|2015 ONSC 3580.

[3] *Ibid*., para. 38.

[4] [2008] O.J. No. 4218, 48 C.B.R. (5th) 91 (Ont. S.C.).

[5] *Ibid*., paras. 11, 15, 18, and 19.

[6] *Soundair*, [1991] O.J. No. 1137, 4 O.R. (3d) 1 (Ont. C.A.).

[7] The monitor that replaced A&M in the *Nelson* matter (1) reviewed the pre-filing sales process; (2) opined that the market was widely canvassed and appropriate for Nelson's business; and (3) recommended that the credit bid be approved by the court.

• LEASE DEPOSIT CHARACTERIZED AS SECURITY INTEREST: SUMMARY OF *ALIGNVEST PRIVATE DEBT LTD. v. SUREFIRE INDUSTRIES LTD.* •

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In the context of a tenant's bankruptcy, Justice Romaine of the Alberta Court of Queen's Bench recently characterized a deposit provided under a lease as a security interest, as opposed to pre-paid rent, forcing an unsecured landlord to remit the money to a trustee in bankruptcy.[1]

The court emphasized the verbiage of the lease in order to determine the intention of the parties. Among other details, the lease provided that the deposit was "to be held without interest by the Landlord as security for the performance by the tenant of its obligations under the lease".[2] The landlord failed to register a security interest under the *Personal Property Security Act* (Alberta) [*PPSA*].[3] As a result, it was ordered to remit the deposit to the trustee in bankruptcy for a secured creditor who held a general security agreement ("GSA") over the tenant.

The provisions of the lease played a significant role, and the decision emphasizes the importance of carefully drafting the terms in connection with a deposit given under a lease.

Background

Surefire Industries Ltd. ("Surefire") leased its property from York Realty Ltd. ("York") (the "Lease"). In fall 2013, Surefire was placed under receivership but was later declared into bankruptcy—Duff & Phelps Canada Restructuring Inc. was appointed as trustee of Surefire's estate (the "Trustee"). Shortly after bankruptcy, the Trustee disclaimed the Lease, and York retained possession of a deposit made under the Lease for $3,187,500. Alignvest Private Debt Ltd. ("Alignvest") had a GSA over the assets of Surefire and also entered into a priority agreement with York, whereby York acknowledged the validity of Alignvest's security interest and subordinated its own interest to Alignvest's. As previously noted, York did not register its security interest.

York took the position that the deposit should be characterized as pre-paid rent and not security for Surefire's performance of the obligations under the Lease. Therefore, York argued, ownership of the deposit passed on payment and should not form part of Surefire's estate. Alignvest took the position that the deposit secured performance of Surefire's obligations under the Lease and was therefore a security interest. As a result, it should be remitted to the Trustee where Alignvest has priority as a secured creditor.

Law & Analysis

York relied on *Re Abraham* [*Abraham*],[4] where the Ontario Court of Appeal found that a non-refundable deposit to be applied to rental payments or defaults of the tenant was pre-paid rent. On the other hand, Alignvest relied on *Re Champion Machine and Tool Co. Limited* [*Champion*],[5] a case distinguishing *Abraham* on the basis that the deposit was defined as a "security deposit" and was to be retained in the event of a breach of covenant or applied to the last month of rent. In *Champion*, the benefit of the deposit fell to the trustee in bankruptcy and not the landlord.

Without specifically citing the application of *Abraham* or *Champion,* the court stated that it must "look to the wording of the lease to determine the intention of the parties with respect to the deposit, whether it should be characterized as pre-paid rent, liquidated damages or security and whether it would be non-refundable in the hands of the tenant and thus with respect to the trustee in bankruptcy".[6]

Justice Romaine examined the provisions of the Lease that characterized the deposit, which stated the deposit was "to be held without interest by the Landlord as security for the performance by the Tenant of its obligations under the Lease",[7] and if Surefire was not otherwise in default, the deposit was to be applied to rent falling due in the future. Furthermore, the court held the following were indications that the deposit was security:[8]

- The section of the Lease was entitled "Security Deposit/Rent Credit", and the deposit was defined as a "Security Deposit".
- Prior to the receivership, York did not exercise the use of the deposit where rental payments were late.
- The deposit was applicable to future rents only once they fall due.

Based on the wording of the lease and the fact that the deposit could be refunded to Surefire in particular circumstances, the court determined that the parties intended to create a security interest, as opposed to pre-paid rent.

York also submitted that because the deposit was made under a lease (*i.e.*, interest in land), it was therefore excluded from the application of the *PPSA* under s. 4(g). The court rejected this argument, drawing a distinction between "right to payment" under an interest in land and "security for that right". Furthermore, the fact that the deposit may be applied to rent is not relevant—the court held that simply because the parties have chosen a different mechanism to enforce the security, it does not change the characterization of the interest as a security.

Conclusion

The decision emphasizes the importance of drafting precise language with respect to rental or security deposits. As landlords do not typically register deposits under the applicable *PPSA*, they must ensure that their leases do not create an unintended security interest over deposits that are subject to the claims of secured parties.

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[1] *Alignvest Private Debt Ltd. v. Surefire Industries Ltd.*, [2015] A.J. No. 316, 2015 ABQB 148 [*Alignvest*].

[2] *Ibid.*, para. 11.

[3] RSA 2000, c. P-7.

[4] *Abraham*, [1926] O.J. No. 18, 59 O.L.R. 164.

[5] *Champion*, 15 CBR (NS).

[6] *Alignvest*, *supra* note 1, para. 20.

[7] *Ibid.*, para. 11.

[8] *Ibid.*, para. 21.

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