The Canadian Restructuring Framework & Supply Chain Issues

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In recent years, the COVID-19 pandemic has disrupted supply chains across various industries, causing a shortage of goods and services. Global macroeconomic factors have created challenges for companies at every level of the supply chain and have forced companies to examine and reinvent both their supply and sales relationships.

Challenges in supply chain management can evolve rapidly and may pose risks to the viability of a business. This pressure is particularly acute on companies that rely on certain (or sole) suppliers to preserve their business operations. If a critical supplier becomes insolvent, it can result in a cascading effect on the company's operations and ability to meet demand.

This article examines the issues of "critical" suppliers in the insolvency context in Canada. While there are other restructuring options, the Companies' Creditors Arrangement Act (the "CCAA") is the statute used for most large corporate restructurings in Canada. When facing supply chain issues, distressed companies doing business in Canada, along with suppliers to such companies, should be aware of the unique features of Canadian restructurings under the CCAA, including the appointment of a court officer (the monitor) in a CCAA proceeding and the availability of certain critical supply orders that benefit the debtor company by enabling it to continue operating in the normal course during the restructuring period. Suppliers should also be aware of their right to demand cash on delivery or other payment assurances, and their right to refuse to extend credit terms to a CCAA debtor, unless specifically ordered by the court. Lastly, both debtors and suppliers should be aware of the potential for limitations on setoff in a proceeding.

Financial Difficulties

Companies experiencing a liquidity crisis may eventually be compelled to prioritize certain payment obligations such as payroll, vacation pay, sales taxes, and rent. This is particularly true in Canadian insolvencies where there is a statutory priority or personal liability for directors for certain obligations, and the board and management may be motivated to conserve cash for such purposes. As a result, one of the first signs that a company may be struggling is the aging of accounts receivable from an account debtor.

From a supplier's perspective, it is important to closely review the supply contracts for termination provisions prior to an insolvency filing and to carefully consider the credit terms that are extended to the company. Importantly, in a CCAA proceeding, the initial order will typically require a supplier to continue to supply pursuant to its written or oral contracts. It is critical that contracts be clear and that any course of conduct, oral modifications, or termination be documented before the commencement of a CCAA filing to avoid uncertainty.

From a debtor company perspective, supplier management and assessment of supplier financial health are key. When planning for an insolvency, a debtor company will need to analyze which suppliers are at risk for failing to continue to supply, either because they do not have a supply contract or because the supplier itself may face insolvency if outstanding amounts are not paid. When a court officer is involved (including as a proposed court officer assisting with preparation for filing), it is crucial to provide them with visibility into the composition of a company's critical suppliers. As a matter of practice, monitors and proposed monitors review any information that is available and work with the company to assess the financial health of their supplier base. If a supplier is clearly experiencing financial difficulties, it may be necessary to explore alternative sources of supply before any material disruption occurs or take appropriate steps to seek authority to pay pre-filing amounts once a filing occurs. This will be particularly relevant when considering the size and restrictions on a post-filing financing facility.

Moreover, as in many situations, communication is key. Companies should develop and maintain a clear communication strategy with suppliers. A monitor can help prepare a communication strategy for suppliers so that the message is delivered clearly and consistently. In doing so, the company can help manage expectations and mitigate the risk of potential disputes that could result in supply chain disruption. Fostering a sense of trust with suppliers may help to ease tensions and provide for better working relationships moving forward. Ultimately, suppliers only truly gain confidence when a debtor company makes payments on a timely basis at the outset of a filing, and any financing facility in a proceeding should be sized with this in mind.

During a Restructuring Process

Once a proceeding is commenced, a debtor company will need to determine what trade terms, if any, its suppliers will continue to provide. Those suppliers with an interest in a continued relationship and that have confidence in the debtor's ability to reorganize may choose to continue to extend trade credit (sometimes in exchange for other concessions by the debtor company). However, unless specifically ordered by the CCAA Court, the CCAA does not require any party to extend credit to a debtor company, notwithstanding the terms of the existing contract. Suppliers may choose to require COD or parties may negotiate other payment assurances such as letters of credit or partial payment in advance. The monitor can often assist the debtor company with these negotiations, particularly where the supplier is outside Canada and may not fully understand the CCAA process. If the vendor base is largely located outside Canada, recognition proceedings may be required for the orders granted in the CCAA proceedings to be effective in a foreign jurisdiction.

Section 11.4 of the CCAA provides an exception from the general rule that parties are not required to extend credit to a debtor company. Specifically, pursuant to section 11.4(1) of the CCAA, "on application by a debtor … 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." The purpose of these orders

is to require these critical suppliers to continue to supply on credit and therefore provide stability to enable a debtor company to sustain its operations throughout a restructuring process. If the court declares a party to be a critical supplier under this section, the court must make an order that the party who is being forced to supply goods and services on terms consistent with the existing supply relationship (including requiring the supplier to continue to supply on its existing credit terms) is the beneficiary of a charge (or lien) granted in the supplier's favor.

A charge in priority to any secured creditor of the company can only be made on notice to the secured creditors affected by the charge. Section 11.4 of the CCAA has the effect of easing the immediate cash burden on the debtor company and requiring the supplier to bear payment risk if the value of the debtor's assets is insufficient to pay the amounts owing and the court-ordered charge (or lien) is not sufficient to secure outstanding amounts. Ultimately, the decision to use the critical supplier provisions of the CCAA requires scrutiny and consultation with legal counsel, the monitor, and the principal secured creditors.

The CCAA Court also has the jurisdiction to permit payment of pre-filing obligations to a critical supplier. For example, when a supplier is a small business that cannot continue to provide goods and services without payment of pre-filing invoices, when the supplier is in a foreign jurisdiction that will not honor a Canadian court order, or when there is no contract requiring the supplier to continue to supply, the court may authorize the debtor company, typically conditioned on the consent to the monitor, to pay certain pre-filing amounts. There is a risk that if payment of pre-filing amounts is sought to be made to one supplier, others may seek to require payment of arrears before providing supply. Including such a provision in the initial order should not be taken lightly—if the order provides a mechanism to pay pre-filing obligations, debtors should anticipate that creditors will seek to take advantage of that provision.

A CCAA monitor may also provide value by engaging in negotiations with key stakeholders, including creditors, suppliers, landlords, employees, and unions. The monitor can leverage their experience and expertise to maintain and strengthen valuable relationships and provide insight to both the company and its suppliers. In doing so, the company may be able to more efficiently secure post-filing supply. In contentious situations, the court may also be involved in mediating and approving supplier agreements in the restructuring process. This involvement can provide an objective perspective and ensure that the interests of all parties, including critical suppliers, are reasonably considered. Furthermore, when a debtor company can secure debtor-in-possession financing, the monitor can help communicate the extent of the financing available and provide insight into the post-filing cash flow to give suppliers the confidence that the company will have the liquidity required to satisfy post-filing obligations. That said, suppliers often require COD terms for all post-filing supply.

Both debtor companies and suppliers should also be aware of the current state of the law of setoff in CCAA proceedings. Section 21 of the CCAA provides that the law of set off is applicable to a debtor company. When necessary, however, a court may stay the exercise of those rights, and the Supreme Court of Canada has held that pre-filing amounts should not be set off against post-filing amounts, except in very unusual circumstances. Parties wishing to exercise set off rights should carefully review the orders made in the proceeding to determine if a lift stay application is necessary to exercise set off remedies.

Conclusion

The Canadian restructuring framework provides useful tools to both suppliers and debtor companies. It is equally important that both parties be aware of the tools available and know how, and at what stage, to use them. It is also important for both parties to be aware of contractual provisions that may be triggered after a party's financial position changes. Experienced turnaround management professionals—both legal counsel and financial advisors—can help suppliers and debtor companies prepare and carefully plan for a successful restructuring.

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