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EXPECT THE BEST

Supreme Court Offers Some Financiers Protection, Creates New Risks For Others, In Its Decision On *Sun Indalex, LLC v. United Steelworkers*

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If you or your business are experiencing economic challenges, you may need advice on the options available to restoring your business to growth and prosperity. Blaney McMurtry has considerable expertise in this. Please contact John Polyzogopoulos at 416.593.2953 or jpolyzog@blaney.com.

John is a partner in the firm's Commercial Litigation practice group. His practice covers a wide variety of commercial and business matters. This includes helping clients in all aspects of financial restructuring and asset recovery law and assisting creditors, debtors and professionals appointed under the Bankruptcy and Insolvency Act or the Companies' Creditors Arrangement Act.

The Supreme Court of Canada, in a decision that has implications for borrowers and lenders alike, particularly where pension funds are involved, has raised some new hurdles for the country's banks and their business customers and, at the same time, has bolstered protection for lenders of last resort who finance insolvent companies.

The court's decision in *Sun Indalex Finance, LLC v. United Steelworkers*, issued earlier this year, addresses critical questions in insolvency law regarding pension funds and DIP financing.

The decision, which was not unanimous, has drawn a lot of attention from the insolvency law bar. It has been the subject of many articles and even a Wikipedia entry. Here is our assessment of the importance of the decision for clients.

Regarding pension funds, the court confirmed that the Ontario *Pension Benefits Act* contains provisions that establish a deemed trust super-priority in favour of pensioners where an employer is winding up a pension fund. Those provisions make an employer responsible for any deficiency in an underfunded plan, including contributions not yet due. (A pension deficiency refers to amounts owed to the plan but that have not actually been contributed.)

The impact of this decision on lenders such as banks and other financial institutions is significant because it means that unfunded pension liabilities take priority over a bank's security that would normally rank in first position ahead of all other creditors.

DIP financing is a long-standing and necessary tool that allows companies to restructure their affairs successfully. An insolvent company that is under court protection under the *Companies' Creditors Arrangement Act* (CCAA) can obtain financing to continue operations while it remains in control of the management and affairs of the business (hence the term debtor in possession, or DIP, financing). The only way anyone could be expected to lend money to an insolvent company, however, would be if they received a first-ranking priority over all of the assets and business of the debtor company, including over prior first-ranking secured creditors and other creditors, such as the Canada Revenue Agency (CRA) and pension funds.

While the Ontario Court of Appeal had struck down the first-ranking priority granted to the DIP lender in this case, the Supreme Court unanimously reversed that ruling and restored the first-ranking position of the DIP lender.

Impact for DIP Lenders

DIP lenders can take some assurance from the *Indalex* decision that funds advanced during an insolvency proceeding under the CCAA will be well secured. The court's decision is a common-sense recognition of the function served by appropriately-protected DIP lenders. Without the availability of DIP lending, an insolvent corporation may be forced to shut its doors permanently, resulting in a loss of jobs and other harm to the economy. The Supreme Court was clearly alive to the policy considerations and business practicalities at play.

Accordingly, the position of the DIP financer was strengthened by this decision, but curiously only with respect to insolvent corporations seeking protection under the CCAA. Upon bankruptcy and liquidation under the *Bankruptcy and Insolvency Act* (BIA), the priority of many statutory deemed trusts is reversed by the BIA. That includes the super-priority established by the *Pension Benefits Act*.

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Given that different priorities exist depending on whether the insolvent company seeks protection under the CCAA or rather proceeds with a liquidation under the BIA, the decision in *Indalex* encourages both debtors and creditors to "forum shop" by picking the statute that suits them best.

Debtors and their first-secured creditors will now be more inclined to avoid CCAA protection and seek to make proposals under the BIA. It remains to be seen whether the federal government will seek to harmonize the priority rules that apply to proceedings under the CCAA and the BIA, which, after all, are both insolvency statutes that have similar goals.

Lenders in the Ordinary Course of Business

Unlike DIP lenders, lenders in the ordinary course of business will be alarmed by the finding in *Indalex* that the deemed trust established under the *Pension Benefits Act* applies to the entire shortfall in an underfunded defined benefits plan upon its wind-up. Employers are on the hook for the entire deficiency in the fund, including amounts not yet due. Those amounts will form the basis of a potentially large claim that ranks ahead of secured creditors who would normally be in first position.

Lenders will view this as a significant potential liability when considering extending financing to corporations with defined benefit plans. While *Indalex* applies specifically to Ontario, lenders are considering potential risks elsewhere in Canada and, in particular, provinces with pension legislation that include similar protections for plan members.

The impact of *Indalex* on credit and lending practices may be significant. Lenders will be particularly frugal with borrowers who have significantly underfunded plans. The amount of funds available on loans will undoubtedly be reined in, and interest rates can be expected to rise to mitigate the increased risks brought about by *Indalex*.

With increased risk will also come increased oversight or "big brothering" by lenders. Reporting requirements on loans will become more stringent, particularly with respect to reporting on pension liabilities. Lenders will want to be kept well informed about the status of underfunded pension plans in order to react and plan accordingly.

Other steps lenders may take to protect themselves include insisting on prohibitions on pension fund wind-ups and the creation of any new defined benefit plans. Pending further developments in the law, another form of protection available to lenders is the inclusion of bankruptcy triggers in lending agreements. That is, when certain events occur, the borrower will be required to assign itself, or be assigned, into bankruptcy under the BIA, thereby reversing the super-priority granted to pensions. ■