

2012–05 — Houlden & Morawetz On-Line Newsletter

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Headlines

- The Alberta Court of Queen’s Bench considered an application for approval of the fees of a monitor, which application was opposed by the debtor companies. See *Case Updates* [Re Winalta Inc.].
- Notwithstanding objections raised by two secured creditors, the British Columbia Supreme Court granted an order extending the stay in a CCAA proceeding, and also increased the administration charge and imposed a director’s charge. A DIP financing order was also granted. See *Case Updates* [Re Pacific Shores Resort & Spa Ltd.]

Case Updates

[Re Winalta Inc.]

Re Winalta Inc. (2011), 2011 ABQB 399, 2011 CarswellAlta 2237 (Alta. Q.B.)

Deloitte & Touche Inc. (“Deloitte”), Monitor of the Winalta Group, applied for approval of its fees as a monitor under the *Companies’ Creditors Arrangement Act* (“CCAA”). The application was opposed by the debtor companies. Topolniski J. observed that the issue had been the subject of comment by Professor Ben-Ishai and Virginia Torres in “A Cost-Benefit Analysis: Examining Professional Fees in CCAA Proceedings,” by Janis P. Sarra, ed., *Annual Review of Insolvency Law 2009* (Toronto: Thomson Carswell, 2008) page 142 at 169.

The Winalta Group obtained CCAA protection on April 26, 2010. The Group’s assets were worth about \$9.5 million, while its liabilities exceeded \$73 million.

The CCAA proceedings moved swiftly at the behest of the primary secured creditor, HSBC Bank Canada (“HSBC”). It took just six months from commencement to implementation of the plan.

At the time of this application, Deloitte wanted to be discharged and paid. Deloitte requested \$1.155 million for fees and the Winalta Group asked for a \$275,000 adjustment for alleged overcharging. The Winalta Group complained about charges for support and professional staff other than partners’ services; duplication; a 6% administration fee charged in lieu of disbursements (\$50,000); mathematical errors; and charges for internal quality reviews.

The Winalta Group also sought a \$75,000 reduction to the fee as something “akin to punitive damages” for breach of fiduciary duty. It claimed that a breach arose when Deloitte prepared and delivered a net realization value report to HSBC on September 2, 2010 (“September NVR”) that prompted HSBC to refuse funding costs to acquire takeout financing.

Deloitte agreed to deduct its \$10,000 charge for the internal quality review, but rejected the suggestion that the fee was otherwise unfair or unreasonable.

In November 2009, HSBC had entered into a forbearance agreement with the Winalta Group, which owed it in excess of \$47 million. The Winalta Group agreed to Deloitte being retained as HSBC’s private monitor. The Winalta Group also agreed to give HSBC a consent receivership order. The Winalta Group was not a party to the private monitor agreement between HSBC and Deloitte, although it was responsible for payment of the private monitor’s fees. It was aware that the agreement provided for a 6% flat “administration fee” that would be charged in lieu of customary disbursements. Topolniski J. noted that HSBC was in a position of power. It had agreed to support the Winalta Group’s restructuring and to fund its operations throughout the CCAA process on certain conditions, which included that HSBC would be unaffected by the CCAA proceedings and that the initial order would authorize the Monitor to report to HSBC.

The initial order was granted on April 26, 2010. HSBC continue to provide operating and overdraft facilities during the CCAA process. The Winalta Group did not seek DIP financing. Its request for takeout financing to meet the October 30, 2010 cutoff imposed by HSBC

was frustrated when HSBC refused to fund the costs associated with obtaining replacement financing without a \$3 million guarantee. A stakeholder came to the rescue. The Winalta Group was of the view that HSBC's refusal to pay the costs was directly attributable to the Monitor's actions in connection with the September NVR.

The Monitor's interim accounts were sent at regular intervals. They described activities typical of a monitor in a CCAA proceeding, including intense activity in the early phases tapering off as the process unfolded, with a spike around the time of the claims bar date and creditors' meeting.

In its twentieth report to the court, the Monitor stated that its fee was for services rendered in response to "the required and necessary duties of the Monitor hereunder, and are reasonable in the circumstances."

Justice Topolniski noted that there was a scarcity of judicial commentary relating specifically to the fees of court-appointed monitors, which was likely attributable to the limited number of opposed applications for passing of their accounts. In the above referenced article by Professor Ben-Ishai and Ms. Torres, the authors review certain cases addressing CCAA monitors' fees. Most of these cases, rather than focusing on general considerations in determining what constitutes a monitor's "reasonable fee," dealt with specific concerns about professional fees. Given the paucity of judicial comment on the fees of CCAA monitors generally, Topolniski J. noted that guidance is often sought from analogous case law dealing with the fees of receivers and trustees in bankruptcy. She referenced *Belyea v. Federal Business Development Bank* (1983), 44 N.B.R. (2d) 248, 116 A.P.R. 248, 1983 CarswellNB 27, 46 C.B.R. (N.S.) 244 (N.B. C.A.), where the court stated that the governing principle appears to be that the compensation allowed a receiver should be measured by the fair and reasonable value of his services and while sufficient fees should be paid to induce competent persons to serve as receivers, receiverships should be administered as economically as reasonably possible. Topolniski J. also noted that in *Re Hess* (1977), 23 C.B.R. (N.S.) 215, 1977 CarswellOnt 68 (Ont. S.C.), Henry J. warned consumers that: "... It should be borne in mind that the labourer is worthy of his hire. The creditors and the public are entitled to the best services from professional trustees and must expect to pay for them."

Justice Topolniski was of the view that the appropriate focus on an application to approve a CCAA monitor's fees was no different than that in a receivership or bankruptcy. The question is whether the fees are fair and reasonable in all of the circumstances. The concern is to ensure that the monitor is fairly compensated while safeguarding the efficiency and integrity of the CCAA process. As with any inquiry, the evidence proffered will be important in making those determinations.

The Monitor took the position that the Winalta Group had failed to present cogent evidence to show that the requested fee was neither fair nor reasonable. It asked that the court apply a presumption of regularity. Topolniski J. stated that she was not aware of any authority supporting the proposition that there is a presumption of regularity that applies to a monitor's fees. This application was no different than any other. The applicant bore the onus of making out its case. The bald assertion by the Monitor that the fee was reasonable did not necessarily make it so. The Monitor had to provide the court with cogent evidence on which the court could base its assessment of whether the fee was fair and reasonable in all of the circumstances.

Justice Topolniski then reviewed, in detail, all of the non-partner services. With respect to clerical, administrative and IT staff, Topolniski J. concluded that the Monitor had not met the evidentiary burden required of it. The Monitor was to provide, within the next 60 days, affidavit evidence to address the issues, failing which the charges would be disallowed.

With respect to professional staff (non-partner), Topolniski J. was of the view that there was no evidence suggesting that the Monitor's non-partner professional staff was anything but knowledgeable, thorough and diligent, or that their services were excessive, duplicative or unnecessary.

With respect to the issue of duplication of work by partners, Topolniski J. stated that there was no evidence presented to show that there was, in fact, any duplication or that any of the work that they undertook was unreasonable. Those charges were approved.

With respect to the administration charge, the Monitor failed to establish that the charge was fair and reasonable in all the circumstances. The Monitor was directed to issue an account for actual disbursements incurred. Whether the Winalta Group will be pleasantly surprised or disappointed will then be seen.

The issue with respect to mathematical errors was resolved. On the issue of internal quality reviews, the Monitor conceded that the \$10,000 charge should be deducted.

On the issue of breach of fiduciary duty/conflict of interest, Topolniski J. noted that a monitor appointed under the CCAA is an officer of the court who is required to perform the obligations mandated by the court and under the common law. The monitor owes a fiduciary duty to the stakeholders; is required to account to the court; is to act independently; and must treat all parties reasonably and fairly, including creditors, the debtor and its shareholders.

The Winalta Group contended that the Monitor breached its fiduciary duty (and implicitly placed itself in a conflict of interest position) by providing HSBC with the September NVR without its knowledge or consent. The onus of establishing the allegation of breach of fiduciary duty lay with the Winalta Group.

Justice Topolniski first reviewed the monitor's duties and powers as defined by the CCAA and court orders relevant to the allegation. Section 25 of the CCAA was specifically referenced as was section 13.5 of the *Bankruptcy and Insolvency Act* ("BIA").

Justice Topolniski then turned to the provisions of the Initial Order which described the Monitor's reporting functions which were central to this inquiry. She noted that HSBC was an unaffected creditor that continued to provide financing to the Winalta Group by an operating line of credit and overdraft facility. There was no DIP financing as HSBC was, in effect, the interim financier.

Clause 28(d) of the Initial Order provided, in part:

28. The Monitor, in addition to its prescribed rights and obligations under the CCAA, is hereby directed and empowered to:

(d) advise the Applicant's in their preparation of the Applicant's cash flow statements and reporting required by HSBC or any DIP lender, which information shall be reviewed with the Monitor and delivered to HSBC or any DIP lender and its counsel on a periodic basis, but not less than weekly, or as otherwise agreed to by HSBC and any DIP lender.

Clause 30 of the Initial Order provides:

The Monitor shall provide HSBC and any other creditor of the Applicants' and any DIP Lender with information provided by the Applicants in response to reasonable requests for information made in writing by such creditor addressed to the Monitor ...

Justice Topolniski noted that the Monitor's capacity to report to HSBC was limited to the parameters of these two provisions. Topolniski J. went on to note that the Monitor's interpretation of clause 28(d) as authorizing it to prepare and deliver the September NVR to HSBC did not withstand scrutiny. That clause neither expressly nor implicitly authorized the Monitor's conduct in that regard. Further, if the Monitor had had any hesitation about the scope of its authority under this clause (which Topolniski J. was of the clear view it ought to have had), its obligation was to seek clarification from the court before proceeding as it did.

Further, Topolniski J. was of the view that Clause 30 was unambiguous. To a degree, it supported the Monitor's action as its plain and ordinary language permitted the Monitor to release to HSBC information provided by the Winalta Group which it did not declare to be confidential. The Monitor's notes to the September NVR referred to estimated asset realizations, closing dates for certain transactions, and accounts receivable. Presumably, the Monitor obtained that information from the Winalta Group.

Justice Topolniski concluded that the Monitor's estimate of receivership fees, its various calculations, and its analysis stood on a completely different footing. By definition, that was

not “information provided by the Winalta Group.” Clause 30 did not authorize the Monitor to take information legitimately obtained from the Winalta Group and to use it as the basis for preparing and issuing the type of analysis contained in the September NVR report. The Monitor took the position that it would have prepared and given any creditor the type of analysis contained in the September NVR on demand. Topolniski J. was of the view that that did not mean that it was authorized or appropriate for it to do so, particularly without the knowledge and consent of the Winalta Group. Topolniski J. concluded that the Monitor’s interpretation of clause 30 as authorizing it to prepare and deliver the September NVR to HSBC failed to withstand full scrutiny. Read contextually, neither the express language nor the spirit of clauses 28(d) and 30 of the Initial Order authorized the Monitor to issue certain of the information contained in the September NVR. Its authority was limited to relaying non-confidential raw data obtained from the Winalta Group. HSBC could then have interpreted the data (alone or with the assistance of another insolvency practitioner).

Justice Topolniski concluded that the Monitor was not transparent in its dealings with HSBC surrounding the September NVR. Despite any well-intentioned motivation that might have been imputed to the Monitor, Topolniski J. found the Monitor had lost sight of the bright line separating its duties as an impartial court officer and a private consultant to HSBC when it provided HSBC with the analysis in the September NVR, thereby creating a perception of bias. In circumstances where the Monitor ought to have been keenly attuned to heightened sensitivity about perceptions of bias, it should have sought clarification about the reporting provisions in the Initial Order before conducting the analysis in the September NVR and issuing it to HSBC.

Justice Topolniski then addressed the issue of determining if damage was attributable to the Monitor’s conduct, including damage to the integrity of the insolvency system.

In this case, Topolniski J. was of the view that there was no quantifiable loss, nor was there any evidence of damage to the estate. However, the Monitor’s failure to scrupulously avoid a conflict of interest negatively impacted the integrity of the insolvency system. Reference was made to *Re Sally Creek Environs Corp.* (2010), (sub nom. *Re Sally Creek Environs Corp. (Bankrupt)*) 261 O.A.C. 199, 2010 CarswellOnt 2634, 2010 ONCA 312, 67 C.B.R. (5th) 161 (Ont. C.A.), where it was noted that reducing a court appointed officer’s fee is not intended to be punitive, but rather an expression of the court’s refusal to endorse the misconduct.

Justice Topolniski stated that placing a value on the erosion of the public’s confidence is an extremely difficult task, particularly given that the object of the exercise is not to punish the offending party. Arbitrarily choosing a figure as a means of refusing to endorse the misconduct was, in her view, unfair. In the circumstances of this case, Topolniski J. was of the view that the fairer approach was to deprive the Monitor of any charges associated with the misconduct. Accordingly, the Monitor was directed to provide affidavit evidence within 60 days particularizing all charges associated with its analysis of the September NVR, following which the determination will be made as to the appropriate fee reduction.

In the result, Topolniski J. stated that the onus on the application rested with the Monitor to establish that its fee was fair and reasonable and that it had fallen short of doing so in a number of respects. The Monitor had exceeded its statutory and court ordered authority by conducting the analysis in the September NVR and providing it to HSBC. The Monitor had failed to act with transparency in its dealings with its former client and blurred the bright line dividing its duties as a court-appointed CCAA monitor and a private monitor. The Monitor was provided a further opportunity to provide better evidence to address issues relating to separate charges for clerical, administrative and IT staff and to provide further evidence particularizing all charges associated with the analysis in the September NVR, failing which the charges would be disallowed or reduced respectively.

See Houlden & Morawetz, *Bankruptcy and Insolvency Law of Canada*:

N§110 — Security or Priority Charge for Monitors’ Fees

N§115 — Appointment of a Monitor

[Re Pacific Shores Resort & Spa Ltd.]

Re Pacific Shores Resort & Spa Ltd. (2011), 2011 BCSC 1775, 2011 CarswellBC 3500 (B.C. S.C. [In Chambers])

Pacific Shores commenced proceedings under the *Companies' Creditors Arrangement Act* ("CCAA") on October 21, 2011. At the time that the initial order was granted, two of the secured creditors, bcIMC Construction Fund Corporation and bcIMC Specialty Fund Corporation (collectively, "bcIMC") and Fisgard Capital Corporation ("Fisgard") opposed the granting of the order. There was insufficient time to fully hear arguments which were subsequently addressed at a comeback hearing, where the petitioners also sought to extend the stay to December 11, 2011 and to increase the administrative charge from \$100,000 to \$300,000. Further, the petitioners also sought an order authorizing DIP financing in the amount of \$600,000 and the imposition of a directors' charge in the amount of \$700,000.

Fisgard and bcIMC opposed the granting of the order, contending that it was not appropriate in the circumstances and that the petitioners were not acting in good faith and with due diligence; in other words, that the petitioners had not satisfied the test under section 11.02(3) of the CCAA. Fisgard also applied to appoint a receiver over the security held by it relating to one of the developments involved in Pacific Shores.

The corporate group, known as the Aviawest Group (the "Group"), began operations in 1990 with the development of the Pacific Shores Resort. The business of the Group included sales of vacation ownership products, sales of deeded ownership products and management of those interests.

The causes of the Group's insolvency were principally related to the development of the Parkside Resort. There was a substantial amount of evidence detailing the assets of the Group and the outstanding debt against those assets. In respect of Parkside Resort, bcIMC had a first mortgage of \$28.1 million, BCC Mortgage Investment Corporation had a second mortgage of \$8.5 million and bcIMC had a third mortgage of \$20 million. Other debts brought the total of priority claims and secured debt to \$58 million.

In respect of Pacific Shores Resort, Fisgard had a first mortgage of \$8.7 million and the bcIMC and BCC debt on the Parkside Resort was collaterally secured against this property. The total secured debt against this property was \$82 million, although that included the debt collaterally secured relating to Parkside Resort.

bcIMC and Fisgard contended that the CCAA order should not be granted for a number of reasons, as follows:

1. There was no equity in the assets;
2. They had no faith in current management;
3. There was no plan, in that no lender would provide sufficient financing to pay off the secured creditors since there was no equity; and
4. They would not vote for a plan that required them to accept less than what they are owed.

The total value of the assets, accepting the appraisals of the petitioners, was \$88.2 million, which did not include the going-concern value of the Group. The total debt was estimated by the petitioners at \$90.2 million, although the Monitor put that figure at \$99.4 million.

Much of the argument regarding the equity situation concerned the valuations relating to the Parkside Resort, which had secured debt of \$58 million. The petitioners valued the Parkside Resort at \$63.7 million. The position taken by bcIMC was that the appraisals were suspect: bcIMC introduced an appraisal well below the appraisal of the petitioners.

The Monitor had conducted a limited review and concluded that the values in the appraisal of the petitioners were generally supported, with certain provisos. For the purposes of this application, Fitzpatrick J. accepted the value of the Parkside Resort interests as advanced by the petitioners.

With respect to Fisgard, Fitzpatrick J. was of the view that it was apparent that they were well secured.

Justice Fitzpatrick added that there was no doubt that the petitioners were insolvent and that they faced substantial challenges in a restructuring. However, for the purposes of this application, it was evident that there were substantial assets that would be a potential source of refinancing or sale with respect to both Parkside and Pacific Shores Resort.

After reviewing concerns raised by bcIMC and Fisgard, Fitzpatrick J. did not accept their submissions that there was any justification for their lack of faith in management.

bcIMC also took the position that there was no plan or any credible outline of a plan that made any sense. In essence, they took the position that any plan was “doomed to failure” and accordingly, the proceedings should be terminated. Reference was made to *Cliffs Over Maple Bay Investments Ltd. v. Fisgard Capital Corp.* (2008), 2008 BCCA 327, 2008 CarswellBC 1758, 83 B.C.L.R. (4th) 214, 296 D.L.R. (4th) 577, 434 W.A.C. 187, 258 B.C.A.C. 187, 46 C.B.R. (5th) 7, [2008] 10 W.W.R. 575 (B.C. C.A.), where the court disapproved of the granting of an initial order where there was no stated intention by the debtor to propose an arrangement or compromise to creditors. Fitzpatrick J. noted significant differences and that the situation was markedly different than the situation addressed in *Cliffs Over Maple Bay*. Tysoe J.A. stated in *Cliffs Over Maple Bay* at paragraph 31 that it is not a prerequisite that a draft plan be filed at the time of the stay. What is required, however, is that the creditor have a *bona fide* intention to do so while having the protections of the stay under the CCAA. Fitzpatrick J. was satisfied that the Group had a *bona fide* intention to present a plan.

Justice Fitzpatrick then considered the position put forth by the secured creditors that they would not vote in favour of any plan. She was satisfied that circumstances indicated that the actions of bcIMC demonstrated that they were open to negotiations with the petitioners and that those negotiations could possibly result in a refinancing of the debt that would allow the Group to go forward on some restructured basis.

On the issue of DIP financing, Fitzpatrick J. considered the provisions of section 11.2 of the CCAA and in particular the factors set forth in section 11.2 (4). She was satisfied that the requested DIP financing order was appropriate.

Justice Fitzpatrick also commented on the argument of Fisgard that a CCAA proceeding was not appropriate in respect of these Resorts since they were real estate developments. There are a number of cases that considered this issue including *Cliffs Over Maple Bay; Re Encore Developments Ltd.* (2009), 2009 BCSC 13, 2009 CarswellBC 84, 52 C.B.R. (5th) 30 (B.C. S.C.); and *Re Marine Drive Properties Ltd.* (2009), 2009 CarswellBC 285, 2009 BCSC 145, 52 C.B.R. (5th) 47 (B.C. S.C.). She noted that those cases were clearly distinguishable from the present circumstances. In those cases, there were undeveloped or partially completed real estate projects and the court found that it was more appropriate for the secured creditors to realize on those assets in the usual manner. In *Re Forest & Marine Financial Corp.* (2009), 2009 BCCA 319, 2009 CarswellBC 1738, 54 C.B.R. (5th) 201, [2009] 9 W.W.R. 567, 461 W.A.C. 271, 273 B.C.A.C. 271, 96 B.C.L.R. (4th) 77 (B.C. C.A.), at paragraph 26, the Court of Appeal clearly drew the distinction between that situation and one where there is an active business being carried on within a complicated corporate group. Fitzpatrick J. stated that the latter situation was exactly what she was dealing with here.

Despite the setbacks in their businesses, Fitzpatrick J. noted that the petitioners wished to continue their operations within the CCAA for the purpose of developing and presenting a plan to their creditors. This was consistent with the fundamental purpose of the CCAA, as expressed in, for example, *Re Sharp-Rite Technologies Ltd.* (2000), 2000 BCSC 122, 2000 CarswellBC 128 (B.C. S.C.), at paragraph 23; and *Cliffs Over Maple Bay* at paragraphs 27-29. Fitzpatrick J. added that, in her view, this was a highly integrated group and the protections under the CCAA must be for the entire group in order that they can seek a solution to their financial problems as a whole. It may be that individual solutions will be found for particular assets or debts, but that could be accommodated within the CCAA proceedings as currently sought by the petitioners for that integrated group.

Justice Fitzpatrick also added that there were a substantial number stakeholders involved: the petitioners, the secured creditors, the unsecured creditors, the owner groups and strata corporations, the thousands of homeowners and the hundreds of employees. There could be no doubt that a receivership would result in a complete obliteration of every financial interest save for the first and possibly second secured lenders. The prejudice to the other stakeholders was palpable in the event of a receivership.

In the result, Fitzpatrick J. was of the opinion that the petitioners had satisfied the onus upon them to establish that they were acting in good faith and with due diligence and that the making of a further order extending the stay was appropriate. The order was granted as sought, including that the administration charge was increased to \$300,000 and the directors' charge was imposed to a maximum of \$700,000. As noted above, the DIP financing charge was also ordered.

Fisgard's application to appoint a receiver was dismissed.

See Houlden & Morawetz, *Bankruptcy and Insolvency Law of Canada*:

- N§63 — Stay of Proceedings, Generally
- N§64 — Procedure for Obtaining a Stay Order
- N§93 — Debtor in Possession (DIP) Financing, Generally
- N§104 — Stay of Actions against Directors
- N§110 — Security or Priority Charge for Monitor's Fees

