A Systems Approach to Comparing U.S. and Canadian Reorganization of Financially Distressed Companies

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In this Article we compare the systems for court-supervised reorganization of financially distressed companies in Canada and in the United States. 1 Though Canada shares a common language and heritage with the United States, it has rejected many legal doctrines thought to be fundamental to the operation of the U.S. system of bankruptcy reorganization, such as cram down, the estate, the debtor in possession, and the debtor’s option to assume or reject executory contracts. We expected that such differences in doctrine would be reflected in differences in the manner in which the systems in the two

1. We compare only systems of reorganization in which the law plays a role through the oversight of the courts (formal reorganizations) and do not consider informal reorganizations or workouts that are carried out in the shadow of the law.
countries functioned. Instead, we found striking similarities in function. In the conclusion of this Article, we speculate that although lawmakers in the two countries set out to create very different systems, the systems were bound to converge over time toward a steady state in which the parts would form a functional whole. Given that both countries decided to adopt plan-based, court-supervised reorganization regimes, there was a limited range of alternative designs that could result in a functioning system. Functional imperatives such as those that brought about the functional convergence of the U.S. and Canadian reorganization regimes may be the principal determinant of any system that attempts to effect court-supervised reorganization of financially distressed companies through the medium of coordinated plans. If lawmakers do not accommodate these imperatives, participants in the day-to-day operation of the system must find ways of doing so, either through law or in spite of it.

Our thesis has important implications for understanding the reorganization process and, more generally, for the methodology of comparative law. First, it suggests a normative basis for evaluating reorganization law and systems: how well do the subsystems in different jurisdictions combine to support achievement of a common set of system objectives? Second, with regard to the development of reorganization systems, it focuses attention on the decision that matters most: the determination of system objectives. Once the designers of a system decide to effect reorganization under court supervision through the medium of a coordinated plan, they will have relatively little flexibility with regard to other elements of the system. Finally, our thesis suggests that a systems approach may be useful in the cross-border comparison of other kinds of laws that are, like the law of bankruptcy reorganization, embedded in larger systems that have nonlegal components.

A. Methodology

In comparing the reorganization systems of the United States and Canada, we employ what we refer to as a "systems" approach. Our methodology continues the trend away from purely doctrinal analyses in comparative law and provides a new set of tools for analysis on a functional level.

A purely doctrinal approach explains outcomes generated in a legal system by reference to legal rules and constructs. To illustrate, suppose that a debtor firm files a petition to begin a reorganization case.

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2. The tendency of open systems like the reorganization systems studied here to approach a particular "steady state" regardless of the initial conditions from which they begin is referred to in the literature of systems analysis as "equifinality." See LUDWIG VON BERTALANFFY, GENERAL SYSTEM THEORY 142 (1968).
Subsequently, a creditor removes a machine from the debtor's factory. The debtor complains to the court and the court requires the creditor to return the machine. A doctrinal explanation of this outcome might be as follows: the filing of the reorganization case caused a "stay" to come into existence, the creditor's removal of the machine was a "violation of the stay" and therefore a "contempt" of court. The creditor's return of the machine was a "purge" of the contempt. In this illustration, "stay," "violation of the stay," "contempt," and "purge" are all doctrinal concepts. They are not observable events or conditions. Rather, these concepts are used to explain observable events: the filing of a reorganization case, the removal of a machine, and its return. In the parallel world of legal doctrine, the filing of a reorganization case, the removal of the machine, and its subsequent return are described as the imposition of a stay, a violation of the stay that happened to be a contempt, and a purge of the contempt. Doctrinal explanations such as these usually purport to describe a comprehensive system of law that parallels worldly events and in some sense "governs" them.

Comparative law scholars have long acknowledged that doctrinal comparisons of the laws of different countries are unlikely to shed much light on the similarities or differences in the actual operation of their legal systems. Systems that operate very differently may use deceptively similar language; systems that operate similarly may do so through different institutions described in different terminology. For these reasons, comparative law scholars began "insist[ing] on the importance of inquiring into how legal rules and institutions actually operate in practice, and of seeing them in their full social and economic context." There seems to be a long-standing general preference by scholars of comparative law for comparison at this "functional" level over comparison at a purely doctrinal level. To illustrate, a functional

3. In its most primitive form, the idea that legal doctrine is a comprehensive system is best captured in Oliver Wendell Holmes' derisive reference to that system as "a brooding omnipresence in the sky." Southern Pacific Co. v. Jensen, 244 U.S. 205, 222 (1916).

4. At least in the eyes of Legal Realists, the doctrinal descriptions of actual events are not merely innocuous legal jargon. The describer, typically a judge, chooses the manner in which to characterize the actual event and thereby may control the outcome of the case.

5. Comparative law scholars distinguish between law in print (or "in the books") and law in action. See, e.g., MARY ANN GLENDON ET AL., COMPARATIVE LEGAL TRADITIONS 8 (1985); RUDOLPH B. SCHLESINGER ET AL., COMPARATIVE LAW 880–90 (1988). This distinction is the basis of the functional approach. See, e.g., GLENDON ET AL., supra, at 11–12: "legal rules and institutions . . . have to be liberated from the conceptual categories of their 'home system' so that they can be seen purely in terms of the different legal needs they serve."


7. In a lecture at Oxford University in 1965, Sir Oliver Kahn-Freund, a distinguished comparative law scholar, suggested that comparisons should focus on functions rather than legal doctrines and structures and urged the comparative lawyer to see himself or herself as "a comparative physiologist rather than as a comparative anatomist." O. Kahn-Freund, Comparative Law as an Academic Subject, 82 LAW Q. REV. 40, 45 (1966). Professor Kahn-Freund observed that
explanation of the previous example would be that the machine was returned to the debtor because it was necessary to the debtor's reorganization effort and its return would not harm the secured creditor.

Positive policy analysis strives to find functional relationships between rules of law and the objectives to which they are, by hypothesis, directed. Yet, the links between laws and their objectives are rarely direct and often highly complex. As it has done in other disciplines, systems analysis provides a methodology for simplifying complicated positive policy determinations. It encourages the analyst to view the system as a whole, rather than simply the law, as goal-seeking. Rather than thinking of law as mandating the desired result or triggering a chain reaction that achieves this result, systems analysis treats the law as but one component in a complex interactive system that seeks its own goals. In the example provided above, the systemic goals may be the preservation of viable businesses and the protection of secured creditors against loss. These goals are vindicated in subsystems that enforce sanctions against a secured creditor who attempts to seize assets of the debtor and that provide a procedure by which the secured creditor may seek exemption from such enforcement.

Thus, in the perspective of systems analysis, the system under consideration is regarded as goal-seeking and composed of subsystems. The method of analysis is to observe how subsystems function and how they contribute to the achievement of the system's overall purpose. It is important to distinguish the "systems" that are the object of a systems approach from a legal "system" composed entirely of doctrine. When doctrinalists refer to a "system," the reference is likely to be to countries may respond to identical economic and social needs through very different legal and extra-legal techniques that are determined in each case by legal and political traditions. Id. at 45-52, 55-58. He asks: "How can the objectives of comparison be achieved unless the process of comparison is functional throughout? Unless, that is, what is being compared is not that which is formulated and said but that which is being done?" Id. at 54.

8. We use the term "positive" as opposed to "normative."
9. See, e.g., PAUL S. LICKER, FUNDAMENTALS OF SYSTEMS ANALYSIS 5 (1987) ("A system is defined as a set of elements that are related and through this set of relationships, aim to accomplish goals."); DONALD V. STEWARD, SYSTEMS ANALYSIS AND MANAGEMENT 1 (1981) (a system is "a collection of parts and relations between the parts such that the behavior of the whole is a function not only of the behavior of the parts but also of the relations among them."); ERVIN LASZLO, THE SYSTEMS VIEW OF THE WORLD 14-15 (1972) ("The systems view always treats systems as integrated wholes of their subsidiary components and never as the mechanistic aggregate of parts in isolable causal relation.").
10. See, e.g., LICKER, supra note 9, at 5; C. WEST CHURCHMAN, THE SYSTEMS APPROACH 11 (2d ed. 1979) ("Systems are made up of sets of components that work together for the overall objective of the whole. The systems approach is simply a way of thinking about these total systems and their components.").
11. In complex systems, subsystems may in turn be composed of more subsystems. When the observer cannot decompose the subsystems further, the elements of the last system are referred to as "black boxes." LICKER, supra note 9, at 9.
a set of rules of law which they regard as coherent. A systems analyst's reference to a legal system should include the courts, the lawyers, the reorganizing companies, documents, information flows, transactions costs, computer systems, and anything else that plays an observable role in court-supervised reorganizations—including law and ideology. With this broader concept of a reorganization system in which law is only one component, it becomes apparent that many subfunctions can be performed either by law or by extra-legal means. For example, the U.S. reorganization system provides only one legal mechanism, the appointment of a trustee, to displace the debtor’s management if it abuses its authority. That mechanism is seldom employed, leading many commentators to conclude incorrectly that Chapter 11 permits the managers who got the company in trouble to retain their jobs. Those commentators fail to notice the existence of powerful nonlegal mechanisms which almost invariably sweep the managers of large publicly held companies from office before the conclusion of their reorganization cases. These mechanisms went unnoticed by reorganization scholars until recently because they are not recognized in reorganization law.

Another example of the hybrid nature of systems that purport to be purely “legal” is the U.S. system in which notices of security interests are filed (registered) and given legal effect under Article 9 of the Uniform Commercial Code, or similar personal property security acts in Canada. Although law purports to govern comprehensively the effect of these filings, it has in large part deferred to the computer systems used to store and retrieve the records. While computer system designers have no de jure authority to determine the legal effect of the documents being stored and retrieved, they do in fact change the legal effect of those documents through their design of search logic in the software. Only through a sufficiently broad definition of a law-related

13. The statement remains true even when one considers the use of quasi-trustees, persons appointed to act essentially as trustees, but not labeled as such by the court that appointed them. See infra note 158 and accompanying text.
14. Some of these complaints are collected in Lynn M. LoPucki, Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig, 91 Mich. L. Rev. 79, 80 n.3 (1992) [hereinafter LoPucki, Strange Visions].
15. See Lynn M. LoPucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. Pa. L. Rev. 669, 729–37 (1993) [hereinafter LoPucki & Whitford, Corporate Governance] (showing that 95% of the chief executive officers in office at the onset of financial distress were out of office before the confirmation of the Chapter 11 plan).
17. See In re Tyler, 23 B.R. 806 (Bankr. S.D. Fla. 1982) for a dramatic example. In Tyler, the
system is it possible to get at what the system does as opposed to what the law says.

Once a reorganization system is defined in these broader terms, it becomes considerably more difficult to investigate. Where findings from empirical studies were available, we used them to determine the impact of legal doctrine. One of us has conducted empirical studies of reorganizations of large, public companies in the United States that provide direct evidence of the functioning of that system.\(^\text{18}\) Unfortunately, no such empirical studies of the Canadian system have been published.

The source of information that is most accessible is the body of legislation and reported cases. We have made extensive use of it in this Article, but we have been cautious in doing so. In attempting to project the effect of judicial or legislative rules on the operation of the system, we have tried to consider them in context rather than in isolation. Moreover, we considered the possibility that some rules would not be implemented as written. To deal with the paucity of empirical evidence on the Canadian system, we began by speculating about how various actors in the system are likely to respond to the law on the books. Of course, we did so in light of what we supposed were the prerequisites to a functioning system. We incorporated our speculations into early drafts of our paper, and then tested those speculations by discussing them with twelve prominent Canadian bankruptcy lawyers.\(^\text{19}\)

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19. The names of these lawyers appear supra note **. The technique was particularly successful in uncovering some of the methods by which the Canadian system adjusted for lack of doctrinal mechanisms for a debtor to amend or modify a proposal once it was rejected by the creditors or the court. See infra part IV.B.4.c.
In organizing our comparison of U.S. and Canadian reorganization systems, we sought to define the objectives and structure of a formal reorganization system in a manner independent of the laws of either country. In doing so, we hoped to avoid the abstraction and jargon of legal doctrine and to focus on the common functional elements of the systems. To this end, we found it helpful in various contexts to adopt the perspective of affected parties in the system, particularly the debtor or its creditors, who want to know what the system will or will not do or permit them to do. The product of this effort, our functional model, is summarized in the next subsection.

B. A Functional Model of Reorganization

Systems analysis defines a system by listing the elements, relationships and goals of which the system is composed. Observers of a complex web of social interactions, such as that surrounding bankruptcy reorganization, are likely to identify a range of "systems" defined by different boundaries. We decided to restrict the system under consideration to court-supervised reorganizations because the boundaries are defined by a relatively clear decision to invoke the bankruptcy process. Alternatively, we might have defined the system more generally as one that preserves the value of firms in financial distress. It then would have included reorganizations that take place without a bankruptcy filing (also known as workouts) and the liquidation of insolvent debtors. Moreover, even within the boundaries we chose, the goals of bankruptcy reorganization are necessarily somewhat uncertain. It is dangerous to derive the goals from legislative history and judicial opinions because systemic goals often diverge markedly from those perceived by the actors within the system. 20 Even for outsiders, the identification of the objectives of a system is a highly subjective process. We exercised our judgment in listing the premises and goals of U.S. and Canadian bankruptcy systems, and the value of our analysis may depend in large part on whether the reader shares that judgment. Given the foregoing caveats, we proceed in this subsection to describe the framework of the reorganization systems that exist in Canada and the United States.

We first concluded from our observations of the U.S. and Canadian reorganization systems that both were grounded in the following assumptions: (1) some companies in financial distress are worth more

20. See, e.g., LiCKER, supra note 9, at 6, 8 ("The nature of a system is, at least partially, a function of the observer of the system. We call that the Uncertainty Principle. What it means is that in discussing a particular system, we can refer only to our observations, which are at least partly a product of ourselves rather than the system being observed . . . . Those within a system have no direct knowledge of its goals, which can be known directly only from the outside.").

21. We define financial distress as including both the state of balance sheet insolvency
as going concerns than they are if liquidated piecemeal; (2) to preserve these companies as going concerns, their financial distress must be resolved through the adjustment of their contracts with, or legal liabilities to, creditors, shareholders, trading partners, and other stakeholders; (3) in some cases, the necessary adjustments cannot be effected without court supervision, nor can they be effectively specified in advance at the time the debt is incurred or the company formed; and (4) with few exceptions, the decision to initiate formal reorganization proceedings should be made by the debtor. The third assumption, in particular, is subject to considerable controversy. Nevertheless, we submit that these four assumptions are the foundation for the current systems of court-supervised reorganization in both the United States and Canada. In this Article, we refrain from commenting on the accuracy or merit of these assumptions and instead adopt them as the premises for our model. From these premises, we infer the goals of the systems: to reorganize viable businesses while minimizing the losses to all parties during the effort. From those goals, we deduce the functions that must be performed within the resulting system. In the following paragraphs, we identify the subsystems that combine to serve these goals and thereby provide the organizational framework for our comparison of the reorganization systems in the United States and Canada.

First, because these systems rely on debtors to initiate the proceedings, the systems must provide incentives to file. The incentives actually provided under the laws of the two countries are sufficiently strong and general that they promote, to some degree, inappropriate as well as appropriate filings. Both systems therefore contain mechanisms designed for out-of-court agreements with creditors, auction sales of the going concern, and the ex ante design of financial instruments. While the assumption is certainly plausible, it has been debated extensively in the academic literature. See, e.g., Barry E. Adler, Financial and Political Theories of American Corporate Bankruptcy, 45 Stan. L. Rev. 311 (1993); Douglas G. Baird, Revisiting Auctions in Chapter 11, 36 J. & Econ. 633 (1993); Michael Bradley & Michael Rosenzweig, The Unstemable Case for Chapter 11, 101 Yale L.J. 1043 (1992); Elizabeth Warren, The Untenable Case for Repeal of Chapter 11, 102 Yale L.J. 457 (1992); Lucian Bebchuk, A New Approach to Corporate Bankruptcy, 71 Tex. L. Rev. 51 (1992); Frank H. Easterbrook, Is Corporate Bankruptcy Efficient?, 27 J. Fin. Econ. 411 (1990); Lucian Arye Bebchuk, A New Approach to Corporate Reorganizations, 101 Harv. L. Rev. 775 (1988).

signed to identify the inappropriate filings and nullify them. We discuss these mechanisms for triggering reorganization and screening cases for eligibility in Part II.

Second, because the adjustment of contractual rights and obligations is not instantaneous, the system must provide mechanisms to preserve the business as a going concern in the interim. Specifying the terms of adjustment in light of the circumstances that exist at the time of reorganization necessarily takes some period of time, particularly when the debtor in financial distress has a large number of stakeholders. Facts must be gathered, a document must be prepared to describe and memorialize the adjustments, and parties in interest must have the opportunity to read, consider, and react to it. During that time, there is often an operating business that must be preserved. There must be some mechanism to prevent individual creditors from destroying the business through the exercise of their legal remedies. Continuation of the business may require that some of the debtor's trading partners be forced to continue to deal with the debtor, even though the debtor no longer has contract rights it could enforce against them under non-bankruptcy law. In many cases the business will require new financing pending reorganization. When such financing is appropriate, the system must provide the insolvent debtor some means of assuring the new lender priority over existing creditors. In Part III, we describe the subsystems that perform these functions and, in combination, preserve the value of the debtor while the plan is formulated.

Partly to induce managers to bring their financially distressed companies under court supervision, the system ordinarily leaves the authority to make business decisions with the debtor and its management. Most of the systems that monitor and control management in a financially healthy company, however, do not function during reorganization. Shareholders often have little or nothing left to lose, while the automatic stay prevents creditors from exercising the remedies by which they control debtors outside of bankruptcy. As a result, the reorganization system must establish new subsystems for monitoring the business and controlling management. Those subsystems are also discussed in Part III.

Finally, the reorganization system must set the terms upon which reorganization will occur. The terms must be tailored to ensure that the debtor can comply with them without destroying its business or liquidating the assets in a less-than-optimal way. A firm must be able to reorganize without the unanimous consent of the affected parties. Yet, if a reorganization plan is to be imposed on some parties, the system must specify their minimum entitlements and provide an opportunity for those not dealt with appropriately to be heard in opposition to the plan. If the plan is to be voluntarily accepted by hundreds
or thousands of interested parties, there must be a system for representation, negotiation, and voting, as well as some way to bind or otherwise deal with dissenters. We discuss the subsystems that govern the proposal and acceptance of plans in Part IV.

C. The Statutory Schemes

Readers who are not familiar with both the U.S. and Canadian systems may need some basic background information to understand the comparison we present in subsequent parts.

1. Canada

Prior to 1992, few businesses reorganized under the relevant provisions of the Canadian Bankruptcy Act. The system offered debtors protection against unsecured creditors, but not against secured creditors. The limited protection available under the Act was seldom of much use, because most debtors need to bind secured creditors to reorganize.

During the 1980s, debtors began to invoke a short, recession-era statute, the Companies' Creditors Arrangement Act (CCAA), to enable them to reorganize. The provisions of the CCAA are few and remarkably vague. Moreover, they contemplate a debtor who applies to the court for protection from its creditors after it has prepared a restructuring plan. Despite these shortcomings, however, creative Canadian lawyers brought cases under the CCAA, and the Canadian courts gave definition to a reorganization regime through their standard orders and opinions. The CCAA scheme of reorganization became more popular than reorganization under the Canadian Bankruptcy Act because it was capable of binding secured creditors.

Six legislative attempts were made over the past quarter-century to expand the reorganization scheme in the Canadian Bankruptcy Act. As part of that effort, the reformers examined the U.S. reorganization system as a possible model. Although the Canadian government was fully conscious of the judicial developments under the CCAA in the 1980s, it nevertheless proceeded to draft and then introduce amendments to the Bankruptcy Act to provide a more detailed and comprehensive legislative regime which was intended to replace the CCAA.

25. Companies’ Creditors Arrangement Act, R.S.C., ch. C-25 (1985) [hereinafter CCAA]. The Act contains only 20 sections, and when typeset it is only about five or six pages in length.
26. The reform effort began with the formation of a Study Committee on Bankruptcy Law in 1969. Between 1975 and 1984, six bankruptcy bills were introduced in the Canadian Parliament, all of which were unsuccessful. An advisory committee was formed in 1985. Its recommendations led to the 1992 amendments.
The sweeping amendments were enacted in June of 1992 and the Bankruptcy Act was renamed the Bankruptcy and Insolvency Act (BIA).27 The amendments were intended to be the first of two phases of reform. At the conclusion of the second phase, the CCAA was to be repealed. Yet, the repeal of the CCAA, even in the second phase, is currently in doubt, given its success as a reorganization process.28

Both Canadian systems of reorganization are currently in transition. The CCAA has few statutory provisions worth noting, but a rapidly growing body of case law. In contrast, the BIA purports to specify legislatively the core provisions of reorganization, but these provisions have yet to be fleshed out by the courts. Even the relationship between the two regimes is uncertain. Some observers expect the two regimes to converge, allowing Parliament to repeal the CCAA. Others expect the two regimes to attract different types of debtors and develop in the directions that best serve their respective constituencies. There is already some indication that the CCAA will develop into a system for the reorganization of larger debtors with complicated capital structures, while the BIA will be a less expensive alternative for smaller debtors.29 We include both regimes in our comparison for two reasons. First, omitting either would have excluded a rich body of information about Canadian reorganization. Inclusion of the CCAA provides a substantial body of case law, and inclusion of the BIA provides an extensive, newly enacted statutory scheme. Second, the rules or practices under one regime are often the best evidence of what the rules or practices will be under the other.

2. United States

Reorganization in the United States can take place under Chapters 11, 12, or 13 of the Bankruptcy Code. Eligibility for the latter two chapters, however, is sharply limited,30 rendering them relatively un-


28. Indeed, BIA § 66(2) states that:
Nothing in this Act shall be deemed to affect the operation of the Companies’ Creditors Arrangement Act, and the court may order that a proposal made by a corporation pursuant to section 50 be taken up and continued under that Act.

29. For example, Justice Farley commented in Re Lehndorff Partner, Ltd. that it has been generally speculated that the CCAA will be resorted to by companies that are generally larger and have a more complicated capital structure and that those companies which make an application under the BIA will be generally smaller and have a less complicated structure.

Re Lehndorff Partner, Ltd. (1993), 17 C.B.R. (3d) 24 (Ont. Cr. (Gen. Div.)), at 32.

30. Only natural persons owing noncontingent, liquidated, unsecured debts of less than $100,000 and noncontingent, liquidated secured debts of less than $350,000 are eligible to reorganize under Chapter 13. Bankruptcy Code § 109(e). These amounts are widely considered
important. We have elected to include only Chapter 11 in the comparison, principally to avoid confusion. All references to U.S. law in this Article are to Chapter 11 or cases under it.

Chapter 11 is part of a Bankruptcy Code adopted in the United States in 1978. The reorganization scheme that preceded Chapter 11, like the pre-1992 Canadian Bankruptcy Act, gave debtors limited ability to bind secured creditors. Largely for that reason, the reorganization provisions of the former law were not widely used. Chapter 11 greatly expanded debtors' ability to bind secured creditors. During the fifteen years since Chapter 11 was implemented, there have been few legislative changes, and Chapter 11's once rapid process of evolution through judicial interpretation has settled down. Whatever its merits, Chapter 11 is a mature system. There is, however, considerable dissatisfaction with the system in the United States, and Congress is expected to enact legislation this year that will create a commission to review the U.S. bankruptcy laws, including Chapter 11.31

In the next three parts of this Article, we compare the U.S. and Canadian systems with regard to how each performs the various functions that contribute to the process of court-supervised reorganization. Typically, we begin each section with a description of what is common to the two systems and then turn to the differences. As will be apparent, most of the differences exist only in legal doctrine. Functionally, the two systems are quite similar.

II. INITIATING REORGANIZATION CASES

A. Triggering Reorganization

Both the U.S. and Canadian systems rely principally on the debtor's management to bring the debtor into formal reorganization at the appropriate time. They provide incentives to file by offering legal protection to both the company and its management from the threat of various creditor remedies available outside of bankruptcy, particularly the seizure of firm assets.32 The protection comes principally in

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31. Perhaps the most important proposal for reform would create a new Chapter 10 procedure for the reorganization of small businesses. See S. 540, 103d Cong., 1st Sess. (1993). This separation of court-supervised reorganization cases into different procedures based on the size of the business parallels what many see as the evolutionary direction of the Canadian system. See supra note 29.

32. See infra part IIIA. The debtor is usually guaranteed the time necessary to initiate reorganization proceedings. For example, in Canada, the debtor must be given ten days notice before a secured creditor may enforce a broad security interest against all or substantially all of the debtor's (a) inventory, (b) accounts receivables, or (c) other property. BIA § 244.
the form of a stay, essentially an injunction, against exercise of those remedies. Reorganization law also protects management by allowing it to remain in office, at least temporarily, and to have a central role in formulating the reorganization plan or proposal.33

In both countries, it is possible for creditors to initiate the reorganization case, but in neither country is it common for them to do so. In the United States, creditors can petition to force a debtor into reorganization, but the procedure is risky and difficult.34 While creditors cannot directly initiate a reorganization under the BIA, they may petition for a receiving order that places the debtor in bankruptcy liquidation.35 Once a bankruptcy trustee is appointed, the trustee can initiate reorganization proceedings by filing a proposal.36 This combination of events is functionally equivalent to an involuntary reorganization petition in the United States and is likely to be as rare. The CCAA permits direct initiation of reorganization on the application of a single creditor, secured or unsecured, but the court has discretion to accept or deny the application.37

B. Defining Eligibility for Reorganization

In both countries, most reorganizing debtors are corporations.38 Neither country entirely excludes from formal reorganizations natural

can initiate a reorganization even after bankruptcy liquidation proceedings have been commenced by or against it. See Bankruptcy Code § 706(a) (authorizing the debtor to convert a liquidation case, including a liquidation case that was initiated by creditors, to reorganization). Under the BIA, a bankrupt may file a proposal, but not a notice of intention to file a proposal. BIA §§ 50, 50.4 (only an insolvent person can file a notice of intention and § 2 defines “insolvent person” to exclude a bankrupt). An application under the CCAA may be made by a bankrupt. CCAA §§ 4-5, 2 (definition of “debtor company” includes a bankrupt).

33. For a discussion of the debtor’s control over the business, see infra parts III.D and IV.A.

34. Only about 15% of Chapter 11 cases are initiated by creditors. See Susan Block-Lieb, Why Creditors File So Few Involuntary Petitions and Why the Number is not Too Small, 57 BROOK. L. REV. 803, 865 (1991) (18.45% in the most recent year, 1988); LoPucki & Whitford, Corporate Governance, supra note 15, at 757 (14% for study of large, publicly held companies from 1979 to 1988). To initiate an involuntary case, typically at least three creditors must join in the petition and prove that “the debtor is generally not paying such debtor’s debts as such debts become due.” Bankruptcy Code § 303(h)(1). If their attempt is unsuccessful, the court may require that they pay the debtor’s costs and attorneys’ fees and, if the court determines that they filed in bad faith, the debtor’s damages, including punitive damages. Bankruptcy Code § 303(i).

35. BIA § 43(1).

36. BIA § 50(1)(c). Alternatively, the BIA permits a reorganization proposal to be filed by a receiver appointed by a creditor with security interest in most of the debtor’s inventory, receivables, or other property. BIA §§ 50(1)(b), 245(2).

37. CCAA §§ 4-5, 11.

38. The laws of both Canada and the United States exclude debtors engaged in certain businesses from reorganization under the generally applicable procedures with which our study is concerned. The apparent rationale is that the process of reorganizing these businesses is sufficiently different as to justify a distinct legal regime.

In both countries, the general laws governing reorganization do not apply to banks, insurance
persons who operate businesses as sole proprietors. Both, however, seem ambivalent about permitting sole proprietorships to reorganize under the same procedures as corporations. In the United States, both corporations and individuals can reorganize under Chapter 11, while only natural persons can reorganize under Chapter 13. \(^{39}\) In Canada, both corporations and individuals can reorganize under the BIA, \(^{41}\) while only corporations can reorganize under the CCAA. \(^{42}\)

To be eligible for reorganization in either country, the debtor must be in financial difficulty and be capable of reorganizing. Companies are not barred from Chapter 11 simply because the value of their assets exceeds the amount of their liabilities; companies that are solvent in

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40. See supra note 30.
41. Either an insolvent person or a bankrupt can file a proposal, BIA § 50(1), but only an insolvent person can file a notice of intention, BIA § 50(4). The insolvent person or the bankrupt can be a natural person. BIA § 2 (defining "bankrupt," "insolvent person," "person").
42. Only a company can apply under the CCAA and the definition of company is limited to corporations. CCAA §§ 4, 5, 11, 2 (defining "company"). But see Re Lethandoff Partner, Ltd. (1993), 17 C.B.R. (3d) 24 (Ont. Ct. Gen. Div.) (limited partnership was granted CCAA protection). Indeed, a 1953 amendment limits CCAA eligibility to debtors who have outstanding "an issue of secured or unsecured bonds ... issued under a trust deed or other instrument running in favour of a trustee." CCAA § 3(a). The legislative intent was to ensure that the Act was used only by firms with complex capital structures. During the debates in the House of Commons, the Minister of Justice said that the requirement would ensure that companies using the CCAA process would have "complex financial structures and a large number of investor creditors." Implicit in this statement is the premise that smaller companies with simple capital structures should be able to restructure on a consensual basis or can be sold to a third party as a going concern. This sense is consistent with the leading scholarly article on reorganizations in Canada at that time. See Stanley E. Edwards, Reorganizations under the Companies' Creditors Arrangement Act, 25 Can. Bar Rev. 587, 592 (1947). With one exception over the past four years, however, the courts have ignored this legislative intent by permitting a debtor to qualify by issuing debt under instant trust deeds, created on the eve of its CCAA application, under which bonds are issued for nominal amounts. E.g., Re United Maritime Fishermen Co-op. (1988), 67 C.B.R. 44, at 55-56 (N.B.Q.B.); Re Stephanie's Fashions Ltd. (1990), 1 C.B.R. (3d) 248, at 250-51 (B.C.S.C.); Re Chef Ready Foods Ltd. (1990) 51 B.C.L.R. (2d) 84, at 86; Elan Corp. v. Comiskey (1990), 1 O.R. (3d) 289, at 306-10 (Ont. C.A.), Doherry, J.A. Therefore, as the one dissenting court observed, the requirement has been effectively turned into an entrance fee. Re Norm's Hauling Ltd. (1991), 3 W.W.R. 23 (Sask. Q.B.). Nevertheless, many observers speculate that the CCAA may continue to be the reorganization vehicle of choice for large debtors, while the BIA will be used more frequently by small businesses. See supra note 29.
the "balance-sheet sense" commonly reorganize under Chapter 11.43 Nevertheless, debtors entering Chapter 11 must be experiencing financial difficulty.44 Superficially, Canadian law appears different in that both the CCAA and the BIA limit access to reorganization to debtors already in bankruptcy liquidation45 and debtors who, though not in bankruptcy liquidation, are "insolvent."46 But the difference turns out to be largely semantic. Canadian law defines "insolvent" to include circumstances where the debtor's assets exceed its liabilities, but where the debtor is nevertheless unable to meet, or has ceased to pay in the ordinary course of business, its obligations as they generally become due.47 Thus, under Canadian law, almost any debtor in financial distress is "insolvent" and eligible for reorganization.

There are a few differences in the standards of eligibility for reorganization. First, under the CCAA, courts may deny access to reorganization if the debtor does not have both a reasonable explanation for its financial difficulties and a brief outline of its plans to restructure its business.48 Most courts in the United States do not impose such requirements.49 Second, in cases where a secured creditor that will

43. See, e.g., LoPucki & Whitford, Bargaining Over Equity's Share, supra note 18 at 166, 176 tbls. IV.A and IV.B.
44. Our assertion that financial difficulty is a condition of eligibility for filing under Chapter 11 may surprise some U.S. observers, because it is frequently noted in the United States that Chapter 11 contains no express financial standards for eligibility. Nevertheless, it is clear that if a debtor files while not experiencing financial difficulty, its creditors may have the petition dismissed on the grounds that it was not made in good faith. See, e.g., In re Manville Forest Products Corp., 31 B.R. 991 (S.D.N.Y. 1983); see generally, Lawrence Ponoroff & F. Stephen Knippenberg, Legal Theory: The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy, 85 Nw. U. L. Rev. 919 (1991).
45. Under the BIA, a bankrupt might be solvent if it has committed an act of bankruptcy and is petitioned into bankruptcy by its creditors. BIA § 43(1) (petition for receiving order), § 42 (defining acts of bankruptcy).
46. BIA §§ 50, 50.4. CCAA §§ 4, 5, 2 (defining "debtor company"). The debtor may make a CCAA application if it has committed an act of bankruptcy as defined in BIA § 42, even if it is neither insolvent nor bankrupt.
47. BIA § 2 (defining "insolvent person").
48. For example, in the case of Bargain Harold's Discount Ltd., the debtor's application was opposed by several secured creditors and was dismissed by the court. In his judgment, Austin, J., commented:

[T]he applicant still does not know the precise nature of the problem which brought about its financial circumstances. According to its own auditors, the cause or causes may never be known. . . . [T]he applicant has no specific idea how its operation can be salvaged, other than to suggest "downsizing." There is no reason to believe that downsizing can be done any more efficiently by the applicant than by a receiver . . . . [There is a] complete loss of confidence in management of the company. To this is added the failure of the applicant to suggest who the new management might be.

49. Although the evidence goes little beyond the anecdotal, it appears not to be at all unusual for U.S. debtors to deflect inquiries early in the case about their plans for reorganization on the basis that they have not yet had time (during reorganization) to assess their business or determine what they can do. See Lynn M. LoPucki, Strategies for Creditors in Bankruptcy Pro-
dominate its class in voting has announced in advance that it is unwilling to accept any plan that might be proposed, some Canadian courts have denied access to the reorganization process or have terminated the process very shortly after its inception. Others, however, have noted that if the company is viable, there is a possibility that the secured creditor may change its mind or that the debtor may find a new lender willing to lend enough money for the debtor to pay the objecting lender in full prior to the vote. Thus, they have allowed the case to proceed in the hope that one of these things would occur. Moreover, we describe below the Canadian mechanisms that dilute the secured creditor's veto power in order to serve the functional need to reorganize such a company. As a result, the Canadian courts increasingly allow the formal reorganization of companies that the courts regard as viable despite the objection of even a major secured lender.

The BIA gives the courts similar authority to terminate cases immediately after they are begun if the debtor is unlikely to make a viable proposal that will be accepted by its creditors or if the creditors as a whole would be materially prejudiced by the continuation of the reorganization attempt. Courts under the BIA have suggested that
they intend to apply the same principles that they use to terminate cases under the CCAA.54

C. Screening Cases for Eligibility

Reorganization systems screen cases for eligibility by two methods. The first and most prominent is to afford creditors and other parties in interest the opportunity to challenge the debtor's eligibility in court. The second is to require that a member of a licensed profession (a gatekeeper) vouch for the case by participating in its filing; if no member of the profession is willing to do so, the case cannot proceed.

Although all three reorganization systems afford creditors the opportunity to challenge the debtor's eligibility, they do so only after the reorganization has commenced and the stay has been imposed. A CCAA case is initiated by an application to the court.55 Under one common CCAA procedure, the court holds an ex parte hearing immediately upon filing, makes a preliminary determination of the debtor's eligibility for reorganization, and, if satisfied, enters an order granting the application and staying the collection activity of creditors.56 Creditors are then given notice and the opportunity to apply to have the initial order set aside or varied. Another common procedure is to direct that notice be given to creditors so that they can challenge the application before it is granted.57 Functionally, there is little difference between the two procedures. Even though the court does not imme-

54. Compare Re Triangle Drugs Inc. (1993), 12 O.R. (3d) 219 (Ont. Ct. (Gen. Div.)), where Farley, J., granted termination when a creditor with over half of unsecured debt had lost confidence in the management of the debtor and said it would vote against any proposal, with Re N.T.W. Management Group Ltd. (1993), 19 C.B.R. 162 (Ont. Bankr.), where Chadwick, J., held that the objecting creditor did not prove on a balance of probabilities that the debtor would not be able to arrange take-out financing.

55. The CCAA statute contemplates that a debtor already has a prepared plan of compromise or arrangement when it initiates CCAA proceedings. It therefore provides for an application to the court for meetings of unsecured creditors, secured creditors, and shareholders. CCAA §§ 4, 5. It also permits the debtor to apply for orders staying the activities of third parties. CCAA § 11. The courts have allowed debtors to apply for protection under the CCAA before they have prepared a plan.


57. Ex parte hearings on CCAA applications are relatively rare in Ontario. See, e.g., Re Inducor Dev. Corp. (1992), 8 C.B.R. (3d) 736, at 738 (debtors face a "very high hurdle" in persuading the court that notice is not feasible). Ex parte orders are more common in provinces other than Ontario. The courts sometimes adopt an intermediate position and impose a short initial stay period in which the debtor can serve its creditors with the ex parte order and apply for an extension. The creditors can then challenge the appropriateness of the CCAA proceeding in the extension hearing. See, e.g., Re Westar Mining Ltd. (1992), 14 C.B.R. (3d) 88 (N.S.) (court granted interim stay order on May 14, 1992 and fixed June 3, 1992 as date for hearing applications to vary).
diately enter a stay under the second, creditors are expected to conduct themselves essentially as though the court had done so. Under either CCAA approach, creditors get notice and a very quick opportunity to challenge the application. If the court determines that the debtor is unsuitable for reorganization, the courts will deny the application or, if it has already been granted, terminate the case.

The BIA screens cases by both methods: it allows creditors to challenge the reorganization and provides for the participation of a gatekeeper. In its use of the first, the BIA is similar to the CCAA, though not quite so immediate. A BIA case is initiated by the filing of a proposal, or more commonly, by the filing of a notice of intention to make a proposal. No judicial action is necessary. Notice of the filing is sent to creditors within five days. Creditors then may move to terminate the case on the grounds that the debtor is not an appropriate candidate for reorganization. The second method of screening under the BIA requires, as a condition of filing, that every debtor retain a licensed trustee who is willing to serve in the case. The notice of intention, which initiates the BIA case and gains for the debtor the protection of the stay, must name the trustee and certify that the trustee has consented in writing to serve. Within ten days after the notice of intention, the debtor must file a projected cash flow statement, as well as a report of the trustee on the reasonableness of that statement. The trustee has a continuing obligation during the case to report on the debtor's financial condition and future prospects. If the debtor is incapable of reorganizing, the trustee will be placed in the uncomfortable position of reporting facts that will result in termination of the reorganization case of the debtor who hired it.

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58. Ontario judges generally require notice of application to be given to the applicant's creditors. Justice Farley has commented:

the creditors should not take advantage of such notice to precipitate action they would ordinarily not have been able to take had they had no notice . . . . There should be relief from that sort of "unfairness" on a nunc pro tunc basis in the circumstances.


59. BIA § 50.4(1).

60. BIA § 50.4(11). See supra note 53 and accompanying text.

61. BIA § 50.4(10)(b).

62. BIA § 50.4(2). The courts show no inclination to extend this time and if the debtor misses the deadline, bankruptcy is automatic. Re IDG Environmental Solutions Inc., (1993), 16 C.B.R. (3d) 317 (Ont. Ct. (Gen. Div.)). The trustee owes a duty of good faith and reasonable care. BIA § 50.4(5).

63. See, e.g., BIA § 50.4(7)(b) (trustee must report on the insolvent person's business and financial affairs in connection with hearing on extension of debtor's time for filing plan); BIA § 50.4(9)(b) (one issue on extension will be whether debtor "would likely be able to make a viable proposal.").

64. See infra part III.E.
a trustee to serve on its case and, as a result, may be effectively prevented from reorganizing under the BIA.

Although Chapter 11 screens both by creditor challenge and professional gatekeeping, the challenge process is slower and the gatekeepers are less demanding. The debtor can initiate a Chapter 11 case simply by delivering to the clerk of the court a petition, a list of names and addresses of creditors, and the filing fee. When these items are included, the clerk has no legal authority to reject the filing. Notice of the filing may not be sent to creditors for as long as ten days. While the rules permit creditors to apply immediately for dismissal or conversion of the case to liquidation, it appears to take considerably longer in the United States than in Canada to obtain a hearing on a motion to dismiss or convert a case. Secured creditors may frame their objections to the filing of the case as motions to lift the stay in order to take advantage of the priority such motions receive on the courts' calendars. But even with such priority, it generally takes months to obtain rulings on motions to lift the stay.

The United States does not formally require that the debtor filing the case be represented by an attorney. As a practical matter, however, a debtor can file under Chapter 11 only if the debtor has retained an attorney admitted to practice in the district. Many, if not most, U.S. bankruptcy judges expect the attorneys to screen cases for reorganizability and enforce their expectation by reducing the attorneys' com-

66. Bankruptcy Code § 1112(b).
67. The stay expires unless the court commences a preliminary hearing on a motion to lift the stay within 30 days. The court must commence a final hearing on the motion within an additional 30 days. Bankruptcy Code § 362(c).
68. As many as half of the courts are unable to comply with the statutory deadlines for ruling on motions to lift the stay. KAREN GROSS, PERCEPTION AND REALITY: AMERICAN BANKRUPTCY INSTITUTE SURVEY ON SELECTED PROVISIONS OF THE 1984 AMENDMENTS TO THE BANKRUPTCY CODE 39–50 (1987).
69. As we discuss later in part III.D.2.b., the debtor's attorney performs in the U.S. system some of the functions allocated to the trustee under the BIA. See infra text accompanying notes 178–188. The practical necessity for an attorney to file a case under Chapter 11 may serve as a brake on unwarranted filings in much the same way that the legal necessity for a trustee does under the BIA.
70. The empirical evidence for this proposition is admittedly anecdotal, but the logic for imposing such an obligation on attorneys for debtors in possession is straightforward. To be eligible to file a case, a debtor must have the good faith intention to reorganize, not merely the intention to delay. In re King, 83 B.R. 843 (Bankr. M.D. Ga. 1988) (bankruptcy petition may not be filed solely for the purpose of delay; Chapter 11 debtor must have an intention to reorganize); Cinema Serv. Corp. v. Edbee Corp. (In re Edbee Corp.), 774 F.2d 584 (3d Cir. 1985) (filing Chapter 11 petition for a purpose other than to reorganize when debtor does not have unsecured creditors is an abuse); In re Windall Settlements Trust, 758 E2d 1136, 1137 (6th Cir. 1985) ("If there is not a potentially viable business in place worthy of protection and rehabilitation, the Chapter 11 effort has lost its raison d'être . . .") (quoting In re Ironsides, 34 B.R. 337, 339 (Bankr. W.D. Ky. 1983)). Each time the attorney for the debtor in possession signs and files a petition, pleading, motion, or other paper other than a list, schedule, or statement, the
pensation for handling the case or denying that compensation altogether.\textsuperscript{71} While this practice rarely makes it impossible for a debtor to find some attorney willing to take the case, the identity and reputation of the attorney may itself be regarded by the court and creditors as an important signal about the reorganizability of the debtor.

The principal differences between the U.S. and Canadian systems for screening are differences in timing and permissiveness. Creditors who seek to challenge the debtor's ability to reorganize appear to be able to obtain hearings much more quickly in Canada than in the United States. Perhaps more significantly, U.S. courts appear less inclined than their Canadian counterparts to terminate cases shortly after they are initiated.\textsuperscript{72} Unless the debtor is obviously guilty of some serious abuse, the U.S. courts entertain a strong presumption in favor of giving the debtor "breathing space"\textsuperscript{73} and "the opportunity to reorganize."\textsuperscript{74}

\begin{flushright}
71. Professor G. Ray Warner found that two-thirds of all bankruptcy judges held back fee awards during Chapter 11 cases. \textit{AM. BANKR. INST., AMERICAN BANKRUPTCY INSTITUTE NATIONAL REPORT ON PROFESSIONAL COMPENSATION IN BANKRUPTCY CASES} 117 (G.R. Warner rep. 1991). Although there are purposes for holdbacks other than putting the judge in a position to evaluate the lawyer's work in light of the case outcome, the latter reason is expressly acknowledged in the case law. \textit{See, e.g., In re Energy Cooperative, 55 B.R. 957, 968 n.29 (N.D. Ill. 1985) ("It has become customary for bankruptcy courts to award a flat percentage of interim awards to be paid in circumstances where there is . . . uncertainty as to value of services rendered in terms of results obtained.").} When the court finally decides the amount to be awarded, the court will know, and must take into account, the "results obtained." \textit{See also In re Yankton College, 101 B.R. 151 (Bankr. S.D. 1989).} It is difficult to imagine that a court would not reduce the fees of an attorney whose efforts were expended on the case of an unreorganizable, and therefore unsuccessful, debtor.

72. \textit{See, e.g., In re Craddock-Terry Shoe Corp., 98 B.R. 250 (Bankr. W.D. Va. 1988); In re Shockley Forest Indus., 5 B.R. 160, 162 (Bankr. M.D. Tenn. 1980) (the law is clear that "a court should not precipitously sound the death knell for a debtor by prematurely determining that the debtor's prospects for economic revival are poor").}

73. For example, the Supreme Court of the United States has referred to the Bankruptcy Code's "overall effort to give a debtor-in-possession some flexibility and breathing space." \textit{National Labor Relations Board v. Bildisco & Bildisco, 465 U.S. 513, 532 (1984).}

74. For example, a leading treatise quotes with approval the following passage from \textit{Carolin Corp. v. Miller, 886 F.2d 695, 701 (4th Cir. 1989)}:

\begin{quote}
Such a test obviously contemplates that it is better to risk proceeding with a wrongly motivated invocation of Chapter 11 protections whose futility is not immediately manifest than to risk cutting off even a remote chance that a reorganization effort so motivated might nonetheless yield a successful rehabilitation.
\end{quote}

\textit{DAVID G. EPSTEIN ET AL., 1 BANKRUPTCY § 2-15, at 59 (1992) [hereinafter EPSTEIN ET AL., BANKRUPTCY].}
III. PRESERVING FIRM VALUE DURING FINANCIAL REORGANIZATION

A. Preventing Creditors from Dismembering the Business

In the absence of a bankruptcy or reorganization case, any unpaid creditor can sue the debtor, obtain judgment, and direct the physical seizure of the debtor's property by an officer of the court. Secured creditors may be able to seize and sell their collateral even without invoking the judicial process. In either event, removal of the assets may interrupt the operation of the debtor's business. To prevent such interruption, the BIA, CCAA, and the U.S. Bankruptcy Code each provide for a stay on virtually all collection activity against the debtor during the case or until such earlier time as the court may order. This stay relieves the debtor of the expense and distraction of defending many debt collection actions in various forums and prevents the dismembering of the debtor's business.

There are modest differences in the scope of the stay under the three regimes. It appears that government claims may not be stayed under the CCAA, while they are frozen under the BIA and the Bankruptcy Code. The BIA stay does not affect a secured creditor who took possession of the collateral for the purpose of realization before the notice of intention was filed or who gave the notice of its intention to enforce its security required under Part XI of the Act more than ten days before such filing. The courts are likely to adopt the same rule under the CCAA. United States law is somewhat more protective of the debtor; a secured creditor who takes possession of the collateral before the Chapter 11 case is filed may be required to return the collateral to the debtor.

75. In both Canada and the United States, the officer is typically called "the sheriff." See, e.g., Ontario, Execution Act, R.S.O. 1990, ch. E-24, § 9 (seizure of land), § 18 (seizure of personal property); MONT. CODE ANN., § 25-13-402 (sheriff must execute writ against property no later than 60 days after receipt of the writ).

76. See Bankruptcy Code § 362(a); CCAA § 11; BIA § 69(1). In Canada, the courts also claim to have inherent jurisdiction to stay proceedings. See, e.g., Campeau v. Olympia & York Developments Ltd. (1992) O.J. No. 1946 at 4-9 (Ont. Ct. (Gen. Div.)); Re Lehndorff General Partner (1993), 17 C.B.R. (3d) 24 (Ont. Ct. (Gen. Div.)). Rights of set-off are stayed under all three regimes. Bankruptcy Code § 362(a); BIA § 69.1(1)(a); Quintette Coal Ltd v. Nippon Steel Corp. (1990), 47 B.C.L.R. (2d) 193 (S.C.) (set-off rights may be stayed under CCAA § 11).


78. Bankruptcy Code § 362(a); BIA § 69.1(c).

79. BIA § 69(2).

In both the United States and Canada, creditors may seek to have the stay against their respective enforcement rights lifted during the case. A principal function of such motions in the United States is to challenge the debtor's ability to reorganize.\(^{81}\) Perhaps because the Canadian system offers more direct mechanisms for making such challenges,\(^{82}\) there are fewer motions to lift the stay in Canada than in the United States. As a result, there is relatively little case law under the CCAA concerning the lifting of the stay against creditor enforcement rights. The BIA does not set forth the grounds for lifting the stay with as much specificity as does the Bankruptcy Code, but the effect of the BIA provisions may prove to be similar. Under U.S. law, the court may lift the stay if the debtor fails to provide a secured creditor with "adequate protection" against decline in the value of its collateral during the reorganization case.\(^{83}\) Under the BIA, the fact that a creditor is likely to be materially prejudiced by the continued operation of the stay is grounds for lifting it.\(^{84}\) It may well be that the same acts and circumstances that provide "adequate protection" in the United States may avoid "material prejudice" in Canada. United States law recognizes "cause" as a ground for lifting the stay;\(^{85}\) the BIA authorizes the court to lift the stay if it "is equitable on other grounds."\(^{86}\) It is also possible that Canadian courts might subsume the third ground under U.S. law, that the debtor has no equity in the collateral and does not need it to reorganize,\(^{87}\) in the "equitable on other grounds" language of the BIA.

**B. Preserving Valuable Business Relationships**

As a firm's financial condition worsens, its trading partners may be reluctant to extend credit and may seek to terminate their business relationships. The loss of valuable relationships with suppliers, lessors, and lenders, however, can thwart reorganization. To prevent such losses, both U.S. and Canadian law seek to prevent some trading partners from terminating their valuable relationships with the debtor during the reorganization, while at the same time permitting the debtor to terminate its burdensome relationships with other trading partners.

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81. See infra part III.E.
82. See infra part III.E.
83. Bankruptcy Code § 362(d).
84. BIA § 69.4(a).
86. BIA § 69.4(b).
1. Preserving Contracts Favorable to the Debtor

The survival of the debtor's enterprise during the reorganization process often depends on the continued performance of contracts by nondebtor parties. Yet, as a result of its financial difficulties, a reorganizing debtor is often in material breach of the contracts it needs to enforce. Absent a special rule for reorganization, the nondebtor in such a situation would often have the right to suspend its own performance or even to cancel or to terminate the contract. The debtor would have no right to compel performance.

Both countries have special rules that in some circumstances enable a breaching debtor to compel performance from a nondebtor party. To understand the scope of these rules, it is necessary to distinguish between three scenarios. At one extreme, neither U.S. nor Canadian law permits a nondebtor party to terminate a contract with the debtor merely because the debtor is insolvent or in reorganization. Even if the contract specifies that insolvency or reorganization constitutes a default, such an “ipso facto” clause is unenforceable in most circumstances.\(^88\) At the other extreme, neither U.S. nor Canadian law enables debtors to resurrect agreements that were finally and irretrievably canceled or terminated under nonbankruptcy law prior to the initiation of the reorganization case.\(^89\)

Between these extremes is a common situation in which the debtor committed a material breach of, for instance, a payment obligation, but the nondebtor did not exercise its right to cancel or terminate the relationship before the start of the reorganization case. These executory contracts raise a large number of complex issues in reorganizations; thus, to keep the discussion in this section manageable, we limit our analysis to what are probably the two most common kinds of contracts: continuing agreements for the supply of goods and leases of commercial real estate. With respect to each type of contract, we examine only whether the debtor can compel performance during reorganization even if it has failed to meet its own payment obligations.\(^90\)

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88. Bankruptcy Code §§ 365(e)(1) and 541(c)(1)(B); BIA § 65.1(1). Since CCAA orders preserve contracts even in the face of payment defaults, see infra note 92, they are not likely to allow the nondebtor to terminate by invoking an ipso facto clause.
89. United States bankruptcy law looks to state law to determine when a lease or contract has been canceled or terminated and, if so, whether the termination is irreversible. See, e.g., City of Valdez, Alaska v. Waterkist Corp. (In re Waterkist Corp.), 775 F.2d 1089 (9th Cir. 1985) (even if a lease has been terminated under state law, it can be assumed and revived by the Chapter 11 debtor if state law would permit reinstatement by any means). BIA § 65.1(1) also employs the word “terminate” with regard to the debtor’s contracts with nondebtors. The courts do not appear to have resurrected terminated contracts under the CCAA.
90. In this section, we are concerned about the preservation of the debtor during the reorganization and therefore we focus on the right of the debtor to receive performance of its contracts
a. Contracts for the Supply of Goods

The courts in both countries may compel the nondebtor party to continue to deliver goods or services under a supply contract that the debtor has materially breached by failing to pay for earlier deliveries. Courts typically condition their orders, however, on the debtor's payment for the goods or services delivered during the reorganization period. In the United States, courts usually require immediate cash payment upon delivery. The CCAA courts sometimes permit the debtor to negotiate credit terms with the nondebtor or even to reinstate the pre-reorganization terms. Neither U.S. law nor CCAA orders condition the continuation of nondebtor performance under supply contracts on the debtor's cure of past defaults. The BIA has no provision addressing the debtor's responsibility to cure, but we think the courts are likely to adopt the same approach as under the CCAA for reasons suggested below.

As with other comparisons we have made, the functional similarities described here are achieved through dissimilar doctrinal regimes. The doctrinal regime that "governs" executory contracts in the United States is organized around the doctrinal concepts of "assumption" or "rejection" of contracts. Upon a Chapter 11 filing, an estate is created during the case. There is a distinct set of issues, however, that relate to the post-reorganization period and concern the conditions upon which the debtor is permitted to preserve its favorable long-term contracts after the confirmation of the plan.

91. If a court did not require such payment, the debtor could compel the nondebtor to extend credit, a result which U.S. courts are not prepared to allow. See infra part III.C.1.

92. Courts under the CCAA often require parties who have executory agreements with the debtor for the supply of goods or services to continue to supply the debtor as long as the debtor pays the price in accordance with payment terms negotiated from time to time. See Order in Re Algoma Steel Corp. (Feb. 18, 1991), File No. RE 313/91 para. 11 (Ont. Ct. (Gen. Div.): [All entities] having agreements with the Applicant whether written or oral for the supply of goods or services to the Applicant ... shall continue to supply goods or services pursuant to the provisions of such agreements so long as the Applicant pays the prices or charges under the agreements ... incurred after the date of this Order when the same become due in accordance with the payment terms negotiated by the Applicant from time to time. See also Order in Re Quintette Coal Limited (June 13, 1990), File No. A901507 (B.C.C.S.C.). In other cases, the courts have ordered the suppliers to continue to supply on terms no more onerous to the Company than those in effect immediately prior to the CCAA Order, provided that payment is made promptly by the debtor when due. See, e.g., Order in Re Slade-Peppler Furniture Corp. (Oct. 31, 1991), File No. B301/91 para. 14 (Ont. Ct. (Gen.Div.)). The provisions in the BIA concerning performance of breached executory contracts are limited to licenses and leases where the debtor has made a pre-reorganization payment default. BIA § 65.1(2).

93. It is true that a U.S. debtor must cure if it purports to assume a contract. If, however, it defers its decision, it may be able to compel performance by the nondebtor in the interim without having to remedy its prior breach. Commentators have debated the court's authority to order a nondebtor party to perform its obligations under a contract with regard to which the debtor has neither cured its own default nor indicated its intention to assume. Epstein et al., Bankruptcy, supra note 74, § 5-22, at 486-88. For examples under the CCAA, see supra note 92 (citing cases under the CCAA).

94. See infra text accompanying note 99-100.
to hold the property of the debtor. During reorganization, the debtor corporation is viewed as a shell into which the property will be re vested upon confirmation of the plan. During the reorganization, the decisions of the estate are made by its representative, the debtor in possession. Because the estate is regarded as an entity separate from the pre-reorganization debtor, the pre-reorganization contracts are not binding on the estate (the reorganizing debtor) unless and until it "assumes" them. To assume a contract, the reorganizing debtor must cure its defaults, compensate the nondebtor for any damages, and provide adequate assurance of future performance. Absent a court order to the contrary, the debtor in possession can defer its decision to assume a supply contract until the confirmation of its plan. As long as the debtor in possession defers its decision to assume, its obligations under the contract are not enforceable. The debtor in possession can nevertheless compel performance by the nondebtor pending its own decision. While this right does not follow directly from the debtor in possession's separate existence, it is consistent with the imputed innocence of the newly formed estate.

Canadian legal doctrine contains neither the concepts of assumption or rejection of executory contracts nor that of a reorganization estate. Instead, the ability of debtors to compel the performance of nondebtor parties is explained through the doctrine of the stay. CCAA courts have the discretion to stay any proceeding that might be taken against the company during the case. The courts have interpreted the stay to bar the suspension or termination of contracts. Therefore, the nondebtor must continue to perform. Similarly, the BIA provides that, upon the filing of a notice of intention, no creditor has any remedy against the debtor. The suspension of performance and termination of relationship are contract remedies and are therefore stayed by the filing of such notice. Again, it follows doctrinally that the nondebtor must continue to perform.

95. Bankruptcy Code § 541.
96. Bankruptcy Code § 1141(b).
97. Bankruptcy Code §§ 323(a) and 1107(a).
99. See Epstein et al., Bankruptcy, supra note 74, § 5-23, at 488-89 (explaining that generally the debtor need not perform its own obligations during the case unless and until it "assumes" the contract in order to continue it into the post-reorganization period).
100. CCAA § 11.
102. BIA § 69(1)(b).
b. Commercial Real Estate Leases

All three regimes bar lessors from terminating commercial real estate leases during reorganization for defaults in payment that occurred before reorganization. The BIA qualifies the debtor’s right by giving the court express authority to relieve the nondebtor party from the rules prohibiting termination of leases if those rules are likely to cause the nondebtor party significant financial hardship.103 Under all three regimes, the debtor must pay rent for current occupation immediately when due in order to preserve its rights under a lease during the reorganization case.104 In addition, U.S. law and the CCAA require the debtor to pay any arrearages owing under leases that it wishes to preserve shortly after the start of the case.105 In this regard, the treatment of commercial leases under these two laws is in stark contrast to the corresponding treatment of supply contracts, where the law does not require the cure of past defaults. The BIA rule regarding payment of arrearages under leases is ambiguous because it explicitly addresses only the obligation of the debtor to pay for benefits received under a lease after the filing of the notice of intention,106 but does not address the question of pre-notice arrearages. While there is no case law on point under the BIA, we speculate below that the courts will follow the CCAA and U.S. approach.

While both U.S. law and the CCAA require debtor-tenants to pay arrearages as a condition of continuing their occupation of leased premises, this result too is reached by different doctrinal routes. We described above the U.S. doctrinal concepts of assumption and rejec-

103. BIA § 65.1(6). This provision also applies to licenses. Id.
104. Bankruptcy Code § 365(d)(5) requires that the debtor in possession perform all of the obligations of the debtor under a lease of nonresidential real property. The court has no authority to extend the time for performance beyond 60 days into the Chapter 11 case. Id. Some courts, however, do not grant effective relief to an unpaid lessor. See LoPUCZI, STRATEGIES FOR CREDITORS, supra note 49, § 13.6 (some courts unwilling to forfeit debtor’s interest in the lease for nonpayment); id. § 13.10 (some courts unwilling to require surrender of premises after forfeiture of the lease for nonpayment). Under the BIA, the landlord or licensor may require payment in cash for goods, services, use of leased or licensed property, or other valuable consideration provided after the filing of the notice of intention or proposal. BIA § 65.1(4). Recent CCAA orders require payment of occupation rent. See, e.g., Order in Re Grafton-Fraser (Jan. 10, 1992), File B378/91 (Ont. Ct. (Gen. Div.)) (if occupation rent remains outstanding for more than one business day after notice by the landlord, the court will lift the stay with respect to the leased premises).
105. The cure of pre-petition defaults is prerequisite to assuming the lease; unless the lease is assumed within 60 days after the date of the order for relief (or within such additional time as the court, for cause, fixes within such 60-day period), the lease is deemed rejected and the debtor is required to surrender the property to the lessor immediately. Bankruptcy Code § 365(d)(4). If the lease is assumed, defaults must be cured. § 365(b). Under the CCAA, recent orders have required the debtor to pay arrears. See, e.g., Order in Re Brody’s Town & Country (1957) Ltd. (Dec. 17, 1991), Files B338/91 (Ont. Ct. (Gen. Div.)); Order in Re Grafton-Fraser (Jan. 10, 1992), File B378/91 (Ont. Ct. (Gen. Div.)).
106. BIA § 65.1(2), (4).
tion. In the United States, the debtor cannot defer its decision whether to assume a lease beyond sixty days, or such additional time as the court may permit.\textsuperscript{107} The debtor is obliged, by the rules governing assumption described above, to pay within the sixty-day period arrearages owing on leases it wishes to preserve.\textsuperscript{108} In contrast, the CCAA gives the court discretion to order a stay upon any conditions that it sees fit.\textsuperscript{109} On this basis, CCAA orders have directed the debtor to pay not only occupation rent, but also arrearages. The stay under the BIA is automatic. The court has the discretion, however, to declare the stay inoperative against any creditor subject to any qualifications that the court considers proper.\textsuperscript{110} On this basis, the court may lift a stay subject to the right of the debtor to reinstate the stay by paying arrearages. Thus, all three regimes may reach the same result: the debtor must pay commercial lease arrearages early in the case to retain possession of the leased premises.

2. Relieving the Debtor of Unfavorable Contracts

Under contract law, a promisor usually has the option to breach its contracts and pay damages. Generally, the debtor continues to have this option during reorganization in both the United States and Canada.\textsuperscript{111} An important attribute of this option is that, in most circumstances, the reorganization laws of the two countries permit the debtor to force compromise of the resulting damage claim as part of the reorganization plan.\textsuperscript{112} Here again, however, the two countries have

\begin{itemize}
\item \textsuperscript{107} Bankruptcy Code § 365(d)(6).
\item \textsuperscript{108} While U.S. law requires that the debtor pay arrearages within 60 days of the initiation of the case, some courts have tempered this requirement by granting the debtor extensions to this period.
\item \textsuperscript{109} CCAA § 11 permits the court to prevent landlords from terminating leases. See Feifer v. Frame Mfg. Corp. (1947), 28 C.B.R. 124 (Que. C.A.).
\item \textsuperscript{110} BIA § 69.4.
\item \textsuperscript{111} Bankruptcy Code § 365(a). Under U.S. law, the termination is subject to the approval of the court, but the courts virtually always approve. The standard usually applied for approving a decision to assume or reject a lease or other executory contract is the deferential "business judgment test." See cases cited in Infosystems Technology v. Logical Software, Bankr. L. Rep. (CCH) ¶ 71,899 (D. Mass. June 25, 1987).
\item \textsuperscript{112} A comparison of the treatment of executory contracts in the two countries is difficult because the Canadian system has been preoccupied with the repudiation of commercial leases and has not developed general rules for other contracts either in CCAA case law or under the BIA. Under the CCAA, the ability of the debtor to terminate its leases has been an important issue in a number of recent cases involving insolvent retailers. On the other hand, the REPORT OF THE ADVISORY COMMITTEE ON BANKRUPTCY AND INSOLVENCY, 2d ed. (Ottawa: Queen's Printer, 1986) (the Colter Report) at 58-60, proposed a mechanism for regulating the repudiation of contracts in reorganization, but it was not incorporated into the BIA. Indeed, the BIA is silent on this issue other than with respect to commercial leases. Until Canadian law in this area is clarified, we are forced to extrapolate from the judicial treatment of leases under the CCAA. See infra note 122. From this perspective, it appears that the courts will allow the debtor to repudiate its executory contracts and then modify damages claims in reorganization plans, as it is entitled
\end{itemize}
very different doctrinal explanations of this result. As we describe more fully below, U.S. law deems an "estate" to be created upon the filing of a Chapter 11 petition. Claims arising during the reorganization case are assigned higher priority than general pre-petition claims, and, in most instances, they must be paid in full under a reorganization plan. This general rule would preclude the debtor from forcing compromise of damages claims arising from the breach of contracts during reorganization. The claims ordinarily would be of sufficiently high priority to entitle the holder to payment in full under the plan. Nevertheless, U.S. law avoids this result by deeming the breach to have occurred immediately before the filing of the reorganization petition. The result is to strip the claim of its priority. The CCAA and the BIA do not employ the doctrinal concept of an "estate" used in the United States and, as a general matter, they neither give priority to post-petition claims nor require that they be paid in full as part of the reorganization. Consequently, in both countries the claim for breach of a contract during reorganization is treated the same as a claim that arose before reorganization.

Under contract law in both countries, when one party repudiates its contract, the other party may have the option to accept the repudiation and accelerate the obligation to pay or to wait for the performance of the first party. This rule might be an obstacle to reorganization when a debtor has burdensome contracts whose performance will not fall due until after the reorganization has been completed. If the debtor's repudiation is not accepted by the nondebtor party, there is no damages claim to modify in the reorganization plan. This problem is more

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113. See infra part III.C.2.
114. Bankruptcy Code §§ 541(a) and 1129(a)(9). See infra part III.C.2.
115. See Bankruptcy Code §§ 503(b) and 1129(a)(9).
116. Bankruptcy Code § 365(g)(1). See also Bankruptcy Code § 502(g). For a critique of this exception to the general priority for post-petition claims, see George G. Triantis, _The Effects of Insolvency and Bankruptcy on Contract Performance and Adjustment_, 43 U. TORONTO L.J. 679 (1993).
118. Under U.S. law, see _Samuel Williston, A Treatise on the Law of Contracts_ § 1301 (3d ed. 1968) (hereinafter _Williston on Contracts_); 17A C.J.S. § 429 (1963). See also U.C.C. § 2-708(1) (seller's damages for buyer's repudiation calculated at the time and place for tender). The nonbreaching party in a sales contract can await performance only for a commercially reasonable period of time after an anticipatory repudiation. Otherwise, it might be prejudiced from recovering damages which it should have avoided. U.C.C. § 2-610(a). In some circumstances, the buyer's damages may be calculated at the time of repudiation. See, e.g., _Oloffson v. Coomer_, 296 N.E.2d 871 (Ill. App. Ct. 1973).
pronounced in situations involving long-term leases, because of the legacy of the common law view of a lease as conveying an estate in land. Despite the tenant's repudiation of a lease, the landlord may refuse to permit termination and may instead elect to hold the tenant liable for rent as it comes due until the end of the lease term.119 Unless this rule is modified in reorganization, the effect will be to prevent the debtor from reducing the landlord's rights to damages which the debtor can then compromise as part of the reorganization plan. The landlord could wait until the reorganization was complete, and thereafter enforce the full amount of its claim for the post-reorganization rent installments.

Through its doctrine permitting "rejection" of leases, U.S. law enables the debtor to reduce the landlord's claim for future rent to damages120 and to compromise that claim as part of the plan. In fact, U.S. reorganization law caps the lessor's claim at the amount of the unpaid rent for either one year or fifteen percent of the remaining term of the lease, whichever is greater;121 the remainder of the lessor's claim is extinguished without compensation. Thus, the Chapter 11 debtor has at least as much freedom to breach or repudiate leases and to force compromise of the resulting damages claims as it has with respect to other kinds of contracts.

Canadian reorganization law is unclear as to the circumstances in which the debtor can accelerate future rent installments and force compromise of the accelerated claim under a plan. In recent CCAA cases, the courts have refused to allow the debtor to repudiate its leases unilaterally during reorganization in order to accrue the damage claim, except as part of the reorganization plan.122 Although the debtor can compromise the landlord's claim for damages in the plan, the courts have placed the affected landlords in a class by themselves, thereby

120. See LOPUCKI, STRATEGIES FOR CREDITORS, supra note 49, § 13.9.
121. Bankruptcy Code § 502(b)(6). The section also provides for a global cap on the claim of three years' rent. Id. Generally, the purpose of the cap is to prevent lessors from taking a disproportionately large portion of the estate on the basis of a long-term lease at an above-market rental rate.
122. Order in Re Grafton-Fraser (Jan. 10, 1992), File B378/91 (Ont. Cr. (Gen. Div.)); Order in Re Maher Inc. (Jan. 27, 1992), File No. B21/92 (Ont. Cr. (Gen. Div.)) (order only permitted debtor to accept termination by a landlord). See Jeremy Johnston & Bryan J. Campbell, Tenant Protection Under the Companies' Creditors Arrangement Act: Cramming Down Landlords (1992) (unpublished manuscript on file with the Harvard International Law Journal). For earlier cases that permitted repudiation prior to the plan, see, e.g., Re Inducon Dev. Corp. (1991), 8 C.B.R. (3d) 306 (Ont. Cr. (Gen. Div.)) (order requiring the debtor to give seven days' notice to the landlord); Order in Re Ayre's Limited (Dec. 9, 1991), Sr. J. No. 4283 (Nfld. Sc.) (also imposing a seven-day notice requirement); Silcorp Limited v. Canadian Imperial Bank of Commerce, (June 26, 1992) (Ont. Cr. (Gen. Div.)) [unreported].
giving them a veto over the plan. The result, effectively, is to permit repudiation of leases only with the consent of the affected landlords.

The BIA permits the debtor to repudiate its leases over the objections of the landlord, but only if "the insolvent person would not be able to make a viable proposal, or . . . the proposal the insolvent person has made would not be viable, without the repudiation of that lease and all other leases that the tenant has repudiated . . . ". Read literally, this standard would be an easy one to meet. Almost any debtor could make a proposal under which repudiation of leases would be necessary; the debtor need only propose to commit its resources elsewhere. If the debtor is permitted to repudiate the lease, the debtor's proposal must provide for payment to the lessor, immediately after court approval of the proposal, of compensation equal to the lesser of six months rent under the lease and the rent for the remainder of the lease. This sum may not be compromised in the plan and is the only recovery to which the lessor is entitled with respect to its future rent.

It is too early to conclude that debtors can easily repudiate leases under the BIA. If that proves to be true, however, we would expect that debtors with lease problems will tend to seek relief under the BIA rather than the CCAA. Some of the lawyers we interviewed told us that some debtors already were choosing the BIA over the CCAA because of their need to repudiate leases. If Canadian debtors can opt for the BIA and it is construed to provide for easy repudiation, the Canadian system will then function much as the U.S. system does. It will afford reorganizing debtors the ability to repudiate their unfavorable long-term leases on the payment of relatively small compensation to their lessors.

3. Compelling Third Parties to Deal with the Debtor

The general rule in both countries is that a reorganizing debtor's trading partners need not continue their business relationships with the debtor beyond the requirements of their contracts. There is little authority in the United States, and none in Canada, for requiring a trading partner who is not under contract with the debtor to continue to deal with the debtor during reorganization.

125. BIA § 65.2(3). This cap is difficult to compare to the cap under U.S. law because this entitlement cannot be compromised in the reorganization plan.
126. We know of only two such cases. Ike Kempner & Bros. v. United States Shoe Corp. (In re Ike Kempner & Bros.), 4 B.R. 31 (Bankr. E.D. Ark. 1980) (during the Chapter 11 case, a supplier who had no contractual obligation to do so refused to fill future orders from the debtor.
Both countries make an exception to require public utilities to provide service to reorganizing debtors.127 Continuation of otherwise viable businesses might be impossible without these services. Accordingly, both the U.S. and Canadian laws prohibit public utilities from discontinuing service because of the insolvency of the debtor, the initiation of a reorganization case, or the failure of the debtor to pay for services rendered before the filing.128

United States law specifically authorizes public utilities to require adequate assurance of payment for post-filing service in the form of a cash deposit.129 Under the CCAA, the continuation of service is usually conditioned on the debtor's making payments according to the normal terms. The BIA has no express provision regarding payment for post-filing utility service. The courts are likely, however, to refer to the broader rule stated above with respect to the continuation of executory contracts: that is, the utility may require payment in cash for post-filing goods or services and, as under U.S. practice, is under no obligation to provide further services on credit.130

C. Financing the Debtor During Reorganization

1. Mandating the Extension of Credit

Neither U.S. or Canadian reorganization law requires anyone to extend credit to a reorganizing debtor unless they are obligated to do so by contract or nonbankruptcy law. Similarly, neither U.S. nor Canadian reorganization law will enforce a contract to extend credit to the debtor if the debtor is in default, even if the default is merely the debtor's insolvency or reorganization filing.131 Since the vast majority
of debtors are in default as a consequence of their filing even if they were not beforehand, they cannot compel financing on the basis of their prefilng contracts.\textsuperscript{132}

Once a debtor is in reorganization in the United States, the otherwise binding agreement of a supplier to furnish goods or services to the debtor on credit probably becomes unenforceable.\textsuperscript{133} The BIA rule is functionally similar. It requires that the debtor pay in cash for goods, services, or the use of property provided after filing, even if the contract between the parties required that they be furnished on credit.\textsuperscript{134} By contrast, some CCAA orders have required pre-reorganization suppliers to continue to supply goods and services to the debtor on credit terms that are to be negotiated by the parties\textsuperscript{135} or that are no more onerous to the debtor than those in effect immediately prior to the reorganization.\textsuperscript{136} This difference between U.S. and CCAA practice seems to be confined to trade creditors and has not been applied to lenders.

2. Inducing Extensions of Credit

Both systems permit debtors to induce the extensions of credit they need during reorganization by granting the new lenders priority over

The BIA validates contract clauses that void loan commitments upon the filing of the borrower's reorganization case, making pre-filing commitments that do not contain ipso facto clauses enforceable by reorganizing debtors. BIA \textsection 65.1(4)(b). Under the CCAA, see, e.g., \textit{Re Westar Mining Ltd.} (1992), 14 C.B.R. (3d) 88 at 94 (B.C.S.C.) (court cannot compel a supplier to continue to extend credit during a CCAA case). \textit{See generally, infra notes 135, 136, and accompanying text.}

\textsuperscript{132} Yet, both countries seem to make an exception for letters of credit drawn by the debtor and issued in favor of third-party beneficiaries. The courts have required that the issuer honor a letter of credit, even though the payment triggers the debtor's indemnification obligation and thereby increases its debt to the issuing bank. \textit{Meridian Devs. v. Toronto-Dominion Bank}, \textsuperscript{[1984]} \textit{5 W.W.R. 215, 227 (Alta. Q.B.). The Alberta Court cites approvingly \textit{Page v. First Nat. Bank of Maryland} (\textit{In re Page}), 18 B.R. 713 (D.C.D.C. 1982). See, e.g., \textit{In re Zenith Labs.}, 104 B.R. 667 (Bankr. D.N.J. 1989) (beneficiary of letter of credit permitted to draw on letter after debtor filed for bankruptcy).}

\textsuperscript{133} This assertion is based on \textit{Bankruptcy Code} \textsection 365(c)(2), which provides that \textquotedblleft the trustee may not assume . . . any executory contract . . . if such contract is a contract to make a loan, or extend other debt financing or financial accommodations . . . .\textquotedblright The ambiguity of this provision and lack of authority regarding it are discussed in \textit{Epstein et al., Bankruptcy, supra note 74, \textsection 5-15, at 469-72.}

\textsuperscript{134} \textit{BIA} \textsection 65.1(4).\textsuperscript{135} \textit{See supra note 92. The orders typically provide that the supplier must continue to perform as long as the debtor pays \textquoteright\textquoteright in accordance with the payment terms negotiated by the [Applicant] from time to time.\textquoteright\textquoteright While this language leaves open the possibility that no agreement will be reached, in fact, the circumstances are such that the parties do not seem to have the option of not reaching an agreement. We cannot say whether in the absence of agreement the court would impose terms or apply additional pressure until the parties resolved their impasse, because we were unable to discover any cases in which agreement was not reached. \textit{But see Re Westar Mining Ltd.}, \textsuperscript{[1992]} \textit{B.C.J. No. 1360 (B.C.S.C.)} (court cannot compel a supplier to extend credit during a CCAA case).\textsuperscript{136} \textit{See, e.g., Order in Re Sklar-Peppler Furniture Corp.} (Oct. 31, 1991), File No. B301/91 para. 14 (Ont. Ct. (Gen.Div.)).
pre-filing unsecured creditors. Under U.S. law, credit extended to the debtor during reorganization has priority over pre-petition unsecured claims. If the extension of credit is in the ordinary course of business, the priority is automatic; if the extension is outside the ordinary course, the priority must be authorized by the court prior to the granting of credit. Absent agreement to the contrary, in the United States the debtor can obtain confirmation of a plan only by paying the post-petition provider in full at confirmation. Even if the reorganization fails, post-petition debts will have priority over unsecured pre-petition debts in the ensuing liquidation.

In the United States, the priority of post-petition creditors is explained doctrinally through the concept of the estate. The filing of a Chapter 11 case creates an estate consisting of all of the debtor's property. The property reverts in the debtor corporation only upon confirmation of the plan. Debts incurred by the estate during the Chapter 11 case generally have priority over pre-filing unsecured claims and, unlike the pre-filing claims, must be paid in full as a condition of confirmation of the plan.

Canadian legal doctrine posits neither an estate nor a debtor in possession. The debtor corporation continues to hold its property and its managers generally continue to operate the company in their pre-reorganization capacities. Those who lend to the debtor during reorganization receive no special status by virtue of that fact alone. Nevertheless, debtors whose assets are not entirely encumbered at the time they file for reorganization can functionally replicate much of the post-petition financing regime in the United States by granting security interests. Neither the CCAA nor the BIA expressly addresses whether the debtor can grant security interests to those who extend credit during reorganization. But Canadian courts have recognized that reorganizing debtors can grant security interests just as nonreorganizing debtors can. Several CCAA orders have authorized debtors to

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137. Neither the CCAA nor the BIA has provisions authorizing the debtor to borrow on a secured basis. It can be argued, however, that there is no provision that shrinks the financing opportunities of the debtor from what they were before the initiation of the case. In particular, there seems to be no legal constraint preventing the debtor from granting security over unencumbered assets. See infra note 145 and accompanying text.


139. Bankruptcy Code § 364(b).

140. Post-petition debts have priority as an "administrative expense." Bankruptcy Code § 364(a)-(b). Unless the parties agree otherwise, the court may confirm a plan only if the plan provides for payment of administrative expenses in cash. Bankruptcy Code § 1129(a)(9); see also Bankruptcy Code § 507(a)(1).

141. See Bankruptcy Code § 726(a)-(b).

142. Bankruptcy Code § 541.

143. Bankruptcy Code §§ 503(b), 507(a)(1).

borrow at such interest rates and on such other terms as they can arrange, including the granting of security. Moreover, CCAA courts have expressly given trade creditors security interests in unencumbered assets of the debtor for credit extended after the CCAA application. The granting of a security interest during reorganization in Canada in effect gives the recipient very similar priority to that accorded the financier of the debtor in possession in the United States. That is, the reorganization lender ranks behind pre-reorganization security interests and ahead of pre-reorganization unsecured claims.

In both the United States and Canada, there are cases where the debtor's assets are encumbered to such an extent that the granting of priority over merely pre-petition unsecured creditors offers new lenders little chance of recovery in any subsequent liquidation. In order to offer a post-petition lender meaningful priority, the debtor must be able to grant priority over pre-filing secured creditors. The debtor's ability to do so may, in some cases, be crucial to the success of the reorganization. United States law expressly allows the court to authorize debtors in possession to grant new lenders priority over pre-filing secured creditors in narrowly defined circumstances.

In contrast, neither the BIA nor the CCAA expressly authorizes debtors to grant security interests that prime existing security interests. The apparent stark difference between the two regimes has been bridged to a large extent by the courts in both countries. For instance, there are at least isolated instances in which Canadian courts have authorized senior security interests where the debtor's assets have been fully encumbered. On the U.S. side, the statute protects the expectation interests of affected secured creditors by requiring the debtor to

145. See, e.g., Order in Re Sklar-Peppler Furniture Corp. (Oct. 31, 1991), File No. B301/91 para. 14 (Ont. Crt. (Gen.Div.)); Order in Re Olympia & York Developments Ltd. (May 14, 1992), File No. B125/92 para. 7 (Ont. Ct. (Gen. Div.)) (Olympia & York authorized to borrow such additional sums as it might deem necessary and grant such additional security as it might deem necessary for new advances, on such terms as the court might direct).

146. See, e.g., Re Wescar Mining Ltd., [1992] B.C. No. 1360 (B.C.S.C.) (providing reasons for Order made by Macdonald, J. on June 10, 1992). In other cases, a fund was set aside for the payment of post-filing supplies. See, e.g., Order in Re Silcorp Ltd. and 162969 Canada Inc. (June 18, 1992), File No. B151/92 para. 6 (Ont. Ct. (Gen. Div.)).

147. Bankruptcy Code § 364(d).

148. See Order in Re Willans Investments Ltd. (Feb. 19, 1991), File No. B22/91 para. 10 (Ont. Ct. (Gen. Div.)) (authorizing the debtor to borrow up to $200,000 to finance certain expenditures and to grant security for these borrowings over certain of the company's major assets in priority to existing security interests); Order in Re Silcorp Ltd. and 162969 Canada Inc. (June 18, 1992), File No. B151/92 para. 6 (Ont. Ct. (Gen. Div.)) (varying order giving first charge to secure obligations owed on goods and services delivered after initiation of case). But see Re Fairview Industries Ltd. et al. (Nos. 2) (1991), 297 A.P.R. 12 (N.S.S.C.)(the court stated that the CCAA does not give the courts authority to prime existing secured claims). As an alternative to priming existing security interests, some courts have set aside special cash funds for the payment of suppliers. See supra note 146.
prove that it cannot obtain the loan without granting such a security interest and that the pre-filing secured creditor is adequately protected against loss. The courts appear to apply these requirements strictly and to permit the priming of prior liens relatively infrequently. 149

D. Minimizing Business Losses During Reorganization

For the reorganization to succeed, it is usually necessary that the business of the debtor continue during the reorganization case. Decisions must be made concerning the operations, investments, and financing of the debtor's enterprise. Since it is not feasible for these decisions to be made either by the court or collectively by all interested parties, the reorganization schemes of both Canada and the United States give general decision-making discretion to the management of the debtor. 150 At the same time, however, financial distress creates severe conflicts of interest among stakeholders of the debtor. If unconstrained, the debtor's incumbent managers are likely to make decisions that serve their own interests or the interests of constituencies that enjoy leverage over management at various stages of reorganization, rather than the collective interest of all constituencies. 151 Therefore, while reorganization law in both countries allows the debtor's management to continue to exercise decision-making authority, the law imposes limits on such authority and may restrict its exercise when it severely threatens the interests of creditors. 152 In addition, each system facilitates the monitoring of the debtor's conduct and financial condition and, to some degree, allows for judicial sanctions for managerial misbehavior or poor performance.

1. Limiting the Debtor's Decision-making Authority

Under Chapter 11, the latitude to make decisions allowed to the debtor's management is defined by statute; under the CCAA it is defined by court order. The text of the BIA does not define it, but we


150. See Bankruptcy Code § 1107(a); see also Bankruptcy Code § 1108. CCAA orders generally provide that the debtor maintains possession and control of its assets, subject to the constraints in the order. Under the BIA, the debtor's continued control appears to be implied by § 47(1).


expect that the courts will read in limits similar to those included in orders issued under the CCAA. If so, all three reorganization regimes will delegate to the debtor's management the authority to make decisions in the ordinary course of business,153 permit any interested party to seek court review of any business decision that threatens to prejudice its interests, and require that the debtor seek court authorization for decisions on matters outside the ordinary course of business. Matters outside the ordinary course include, for example, bulk sales of assets, the use of cash collateral,154 borrowing, and the repudiation of contracts. In all three systems, the courts are likely to defer to the business judgment155 of management, even with regard to decisions outside the ordinary course, and approve the path management chooses to follow.

In both the U.S. and Canadian systems, the court that supervises the reorganization has the authority to replace the debtor's management with a government-appointed official. There are, however, some minor differences that may have functional effect. In the U.S. system, the replacement of management by a bankruptcy trustee156 is doctrinally an all-or-nothing proposition; rarely does the official share authority with the debtor's management.157 Perhaps not surprisingly, the U.S. courts are reluctant to order this complete replacement and it seldom occurs.158 There are, however, anecdotal reports of U.S. bankruptcy courts giving examiners limited managerial authority.159

The Canadian system, by contrast, more easily allows for the displacement of management to varying degrees. CCAA orders nearly always appoint a monitor,160 whose primary responsibility is to act as

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153. Most CCAA orders expressly limit management's discretion to carry on the firm's business in the ordinary course. If management wishes subsequently to make a decision outside the ordinary course that is not otherwise authorized by the court's order, it must apply to the court for approval. See, e.g., Order in Re Sklar-Peppler Furniture Corp. (Oct. 31, 1991), File No. B301991 (Ont. Ct. (Gen.Div.)).
156. In the United States, the appointment is either for cause, including fraud, dishonesty, incompetence, or gross mismanagement, or if the appointment is in the interest of creditors, equity security holders, and other interests of the estate. Bankruptcy Code § 1104(a). If the court orders the appointment of a trustee, the U.S. trustee selects the person who will serve in that capacity. Bankruptcy Code § 1104(c). The trustee is usually either an attorney or a professional manager of the type of business involved.
158. See LoPucki & Whitford, Corporate Governance, supra note 15, at 699-703 (trustees appointed in five percent of the largest cases; quasi-trustees appointed in an additional seven percent); LoPucki, The Debtor in Full Control, Part 1, supra note 18, at 124-25 (trustees appointed in about ten percent of smaller cases, but generally only after the critical stages of those cases).
159. See infra note 212.
160. This officer is sometimes called "the information officer," "the administrator," or "the
an information intermediary. In some CCAA cases, however, the order gives the monitor substantial decision-making authority. In a few CCAA cases, courts have appointed custodians to assume control of the debtor’s business.

Under the BIA, the trustee, who serves in every case, is an information officer and does not have decision-making authority simply by virtue of his or her appointment. The BIA parallels the CCAA process, however, by providing that the trustee may be given the powers of an interim receiver if this is necessary for the protection of the estate or the interests of one or more of the creditors. The court has some flexibility in defining the authority thus granted. As an interim receiver, the trustee may be authorized to take possession of all or part of the debtor’s assets and exercise such control over those assets as the court considers advisable.

Despite these differences, some functional imperatives appear to be operating. In both countries, the courts appear highly reluctant to remove entirely the decision-making authority from the debtor’s management. Several concerns are at work. The most frequently cited concern is that the managers’ expertise is necessary to carry on the business. This concern is probably overstated. If a trustee or receiver is appointed to run the business, that person could employ the displaced managers during the case and thereby retain the benefit of their expertise. In any event, the rule that permits debtors to remain in possession and control is too broad to be explained by this concern alone; it is applied even to debtors whose management requires little firm-specific expertise.

Two other concerns may be more important to the functioning of the reorganization system. First, if the filing of a reorganization case results in the removal of managers from control, managers may not cause or permit their firms to file. Second, once a manager is removed

interim receiver,” depending on the scope of his or her duties. Although routine, the appointment of a monitor under the CCAA is discretionary. See Campeau v. Olympia & York Developments Ltd., [1992] O.J. No. 1946 at 4–9 (Ont. Ct. (Gen. Div.)) (firm’s assets were primarily real estate and the court did not appoint a monitor).

161. The monitor typically has three functions: (1) an information intermediary who collects information from the debtor and reports it to the court and interested parties, see infra part III.D.2.b; (2) an advisor to the debtor in the preparation of its reorganization plan; (3) an administrator in connection with the filing of creditor claims and the holding of creditor and shareholder meetings.

162. See, e.g., Order in Re Silcorp Ltd. and 162969 Canada Inc. (June 11, 1992), File No. 152992 (Ont. Ct. (Gen. Div.)) (court gave monitors powers to approve transactions and control disbursements).

163. For example, a custodian was appointed when the debtor had ceased operations and the creditors were concerned about the dissipation of assets. Re NsC Diesel Power Inc. (1990), 79 C.B.R. (N.S.) 1 (N.S.S.C.). See Re Fairview Industries, [1991] N.S.J. No. 453 (N.S.S.C.T.D.) (confirming the authority of the court in this regard).

164. BIA § 47(1), (3).

165. BIA § 47(2).
from control, the manager may refuse to give the cooperation necessary to the reorganization effort. It is interesting in this respect that the English system, which regularly removes managers, contains a number of mechanisms designed to force their cooperation even after they are displaced.

It is unclear why the U.S. system has not developed mechanisms to enable Chapter 11 trustees to share authority with debtors' managements. The answer may partially lie in the extra-legal mechanisms that allow creditors who have lost confidence in the incumbent management of a large, publicly held company to replace them. At least in the United States, the total rate of management turnover far exceeds the rate at which courts remove managers. The ability of creditors in the United States to selectively replace managers—and therefore to exercise control over many of them without actually replacing them—may compensate for the lack of flexibility in shaping the powers and duties of trustees to address the circumstances of each case.

2. Monitoring the Debtor in Possession

During reorganization, the debtor's management typically remains in control of its assets. Subject to the limits described in the previous section, its managers have the broad discretion they would have outside formal reorganization. Yet, those managers may be the same people who brought the debtor into its current difficulties. They may have little financial stake in the business, even if they are also the shareholders, because the debtor is usually insolvent and therefore its losses will be borne principally by the creditors. Moreover, as we have seen, the means of leverage that enable individual creditors to monitor and discipline their debtor are severely undermined by the automatic stay. New systems are therefore needed to perform these functions during reorganization.

As discussed above, reorganization laws give the court considerable power to respond to managerial misbehavior or dereliction of duty. Yet, there must also be subsystems that bring misbehavior to the

166. A few examples of necessary types of cooperation may be helpful in understanding this point. First, managers often have information that cannot be extracted from them in discovery about operations or opportunities that are valuable to the business. Second, particularly among small businesses, business opportunities are often personal to the managers; for example, the debtor may have short-term leases or supply contracts with relatives or personal friends of the manager.


169. See supra note 135, at 727 (citing empirical evidence that creditor pressure forces managers to resign).

170. See supra part III.D.1.
attention of the court. Most of these subsystems are designed to overcome the collective action problems of groups of creditors and to provide monitoring for the benefit of those groups. The subsystems fall into four categories: committees, officers of the court, mandatory disclosure requirements, and appearances in court. We consider each category separately, and find considerable variation in the degree to which they are employed in the three reorganization schemes, but not in their overall functional impact. The debtor appears to be monitored to roughly the same degree in all three regimes.

a. Committees

Chapter 11 provides for the appointment of an official unsecured creditors' committee in every case, and allows for the appointment of other official committees to represent particular classes of creditors or equity holders in appropriate cases.\(^\text{171}\) Later in this Article, we discuss the methods by which these committees come into being, represent their constituents, and finance their activities;\(^\text{172}\) here we focus on their role as monitors. With the approval of the court, these committees can retain lawyers, accountants, or financial advisers to assist them in evaluating the information thus made available.\(^\text{173}\) In relatively large Chapter 11 cases, the committee attorneys actively monitor the case and incoming reports about the business. In smaller cases, the committee system is considerably less effective.\(^\text{174}\) The core of the problem is financial. Courts generally require the debtor to reimburse the committees for the professional fees they incur,\(^\text{175}\) but in a small case, there may be no unencumbered assets with which to make payment. In such cases, no lawyer or accountant may be willing to serve the committees.

Although neither of the Canadian statutes authorizes or requires the formation of creditors' committees, unofficial creditors' committees are active under both the BIA and the CCAA. These committees perform essentially the same monitoring functions as their counterparts in the United States. They typically negotiate an arrangement under which the debtor reimburses all or part of their expenses and fees.\(^\text{176}\)

\(^{171}\) Bankruptcy Code § 1102(a).

\(^{172}\) See infra text accompanying notes 323–330.

\(^{173}\) Bankruptcy Code § 1103(a).

\(^{174}\) Indeed, empirical studies of relatively small Chapter 11 cases have documented a massive failure of the committee system as a means of controlling reorganizing debtors. See, e.g., Timothy J. Curtin et al., Debtors-Out-Of-Control: A Look at Chapter 11's Check and Balance System, 1988 ANNU. SURV. BANKR. L. 87, 92 (80% of survey respondents agreed that creditors' committees were actively involved in fewer than 26% of all Chapter 11 cases); LoPucki, The Debtor in Full Control, Part 2, supra note 10, at 250–53; Jerome Kerkman, The Debtor in Full Control: A Case For Adoption of the Trustee System, 70 MARQ. L. REV. 159, 183–87 (1987).

\(^{175}\) Epstein et al., supra note 74, § 10-14, at 28.

\(^{176}\) See infra notes 329–330 and accompanying text.
b. Officers of the Court

Both the U.S. and Canadian regimes provide for monitoring by various officers of the court.177 A "monitor" is appointed by order of the court in every CCAA case to serve as an information intermediary. Under the typical CCAA order, the monitor is given access to the premises, assets, and records of the debtor for the purposes of investigating the debtor's business and financial affairs. The monitor is responsible for providing periodic reports about the debtor's financial condition, providing special reports in the event of material adverse changes, and monitoring the debtor's compliance with court orders.178 As we noted previously, a trustee serves in every BIA case. The BIA trustee's powers and duties are essentially the same as those of the typical CCAA monitor.179 Particularly in larger reorganizations, the monitors or trustees are likely to be chartered accountants who are insolvency specialists. The debtor usually selects the monitor or trustee before it applies under the CCAA or files under the BIA. The CCAA monitor has often served as the debtor's auditor, although some courts have recently expressed concern about the resulting conflict of interest.180

Chapter 11 provides for the appointment of an examiner to investigate the debtor, but only in limited circumstances.181 Typically, examiners are lawyers and are employed only when intensive investigation becomes necessary because of allegations of fraud, for instance, or misconduct against the debtor's management.182 Examiners are appointed in only a small minority of Chapter 11 cases.

In practice, the officer of the court in the U.S. system who functions most like a trustee or monitor in the Canadian system is the attorney for the debtor in possession. Generally, attorneys in the United States are permitted to serve as advocates for the interests of those who employ them. Special rules applicable to representation of debtors under Chapter 11, however, subtly alter the role of the attorney.183 The large majority of debtors that reorganize under Chapter 11 are corpo-

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177. We use the term "officers of the court" to refer generally to persons who, even if not appointed by the court, owe the court a formal duty of loyalty and, perhaps more importantly, depend on the court for approval of their fees.

178. The role of the monitor has expanded over the past two years and, as indicated above, the monitor has become more active in the reorganization of the business and preparation of the plan. See supra notes 156-157 and accompanying text.

179. BIA §§ 90010, 90-4(7).


181. Bankruptcy Code § 1104 (the examiner's role is "to conduct such an investigation of the debtor as is appropriate").

182. Id.

rations owned by the persons who manage them. 184 These owner-managers select the attorney who will represent the corporation once it is in Chapter 11. Yet, once selected, the attorney can be employed only upon express authorization of the bankruptcy court. To qualify, the attorney must not represent an interest adverse to the estate and must be disinterested. 185 While in theory this rule does not disqualify the attorney from simultaneous representation of the owner-managers and the estate, that is the practical effect of the rule. 186 Attorneys retained to represent debtors in possession typically notify the owner-managers at the time of their employment that, in the event of conflict between the interests of the owner-managers and those of the estate, the attorneys will serve the interests of the estate. 187

Thus, the attorney for the debtor-in-possession under Chapter 11, like the BIA trustee or the CCAA monitor, is a member of a licensed profession, selected by the owner-manager. He or she may have a different perspective as a lawyer than the trustee or monitor, who are typically accountants. The difference, however, may be small because of the tendency of the debtor's attorney in the United States to consult with the debtor's accountant and of the Canadian trustee or monitor to retain legal counsel. The debtor's attorney in the United States, like the BIA trustee or CCAA monitor, is expected to be loyal not solely to those in control of the debtor, but also to the court and all parties in interest.

The attorney for the debtor in possession shares a number of other characteristics with the BIA trustee and CCAA monitor. The attorney is likely to have access to the debtor's property, including its premises, books, records, and other financial documents, and is therefore in a position to assess the debtor's business and financial affairs. 188 Moreover, the fees and expenses of the debtor's attorney are paid out of the debtor's assets, 189 and the attorney's right to be paid has priority over most other claims. 190 In the United States, the court must approve the

185. Bankruptcy Code § 327(a).
187. See, e.g., In re Kendavis Indus. Int'l, 91 B.R. 742 (Bankr. N.D. Tex. 1980) (counsel ordered to repay $2 million in attorney's fees previously awarded by the court because counsel was furthering the interests of the debtor's principals and shareholders rather than acting for the benefit of the estate).
188. BIA § 505.
190. Compare Bankruptcy Code §§ 503(b)(2), 507(a)(1) with BIA § 60(1).
attorney's remuneration. The same is usually true of the monitor's remuneration under the CCAA. Under the BIA, the trustee's remuneration may be set by agreement with the creditors, but the trustee, debtor, or any creditor may apply to have it determined by the court.

The attorneys for Chapter 11 debtors face the same conflict as CCAA monitors or BIA trustees: they are reluctant to bite the hand of the managers that hired them, but have a duty to do so when it is in the interests of the debtor corporation. The principal method of enforcing the attorneys' duty of loyalty is by denying the award of fees or ordering disgorgement of fees already awarded.

c. Mandatory Disclosure

All three reorganization schemes require extensive, mandatory disclosure by reorganizing debtors. The BIA requires that the trustee file various reports during the reorganization case. On filing the notice of intention and later on filing the proposal, the debtor is required to file a statement of its projected cash flow. On each occasion, the trustee must prepare a report on the cash flow statement. If the trustee fails to act in good faith and with reasonable care in reviewing and reporting on the cash flow statements, he or she may be liable to a person who relies on the statement. The trustee also has the duty to report to the official receiver as soon as he or she ascertains a material adverse change in the debtor's projected cash flow or financial circumstances and on such other matters and occasions as the court may direct. Finally, when it files its proposal, the debtor must present a sworn statement showing its financial position at the time of the proposal. A similar practice has evolved under the CCAA without statutory provision. The courts and the creditors generally require that the debtor's proposal be accompanied by an "information circular" that provides sufficient information for the creditors to make an informed judgment about the plan.

In the United States, the disclosure of information by the debtor to the court and interested parties is more direct. Within 15 days after the filing of a Chapter 11 case, a debtor must file schedules describing

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192. BIA § 39(5).
194. BIA §§ 50.4(2); Bankruptcy Form 42.2. In addition, the debtor must make certain representations regarding the preparation of its statement. BIA § 50.4(2); Form 42.3. The debtor must file a revised cash flow statement with its proposal. BIA § 50.4(2).
195. BIA §§ 50.4(2), 50(5).
196. BIA § 50.4(7)(b).
197. BIA § 50(10)(a)(ii).
198. BIA § 50(2).
its assets, liabilities, and executory contracts, and answer a set of questions about its financial affairs. The debtor must appear at a meeting of creditors within a reasonable time after the filing and submit to examination under oath. The debtor in possession must file with the court periodic reports and summaries of operations, including a statement of receipts and disbursements. Along with its plan, the debtor must file a disclosure statement containing information adequate to enable a "hypothetical reasonable investor" to make an informed judgment about the plan. The disclosure statement must be approved by the court and then transmitted to all creditors entitled to vote on the plan. Although Chapter 11 does not expressly require the preparation of a cash flow projection of the kind required of a trustee under the BIA, some courts do require one as part of the disclosure statement. Finally, so long as the Chapter 11 case is pending, the debtor remains subject to discovery as to any matter relevant to the reorganization.

d. Mandatory Court Appearances

At various times during the reorganization case, the debtor must appear before the court and report on its progress toward reorganization. For instance, Chapter 11 gives the debtor the exclusive right to file a plan during the first 120 days of the case. Particularly in large cases, this "right of exclusivity" is considered a crucial element of the debtor's bargaining leverage in plan negotiations. Therefore, debtors routinely ask for extensions of the exclusivity period. Bankruptcy judges commonly grant extensions of exclusivity a few months at a time, and they use the hearings on extensions as an opportunity to monitor the debtor's progress toward reorganization.

Both the CCAA and the BIA bring the issue of progress toward reorganization before the court earlier and more frequently than under Chapter 11. The CCAA stay is typically shorter than the Chapter 11 exclusivity period. Similarly, under the BIA, the debtor initially has

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199. Bankruptcy Rule 1007 and Bankruptcy Form B 200. Bankruptcy Code § 343. This meeting usually occurs about a month after the commencement of the case.
199. Bankruptcy Code §§ 704(b), 1106(a), 1107(a).
201. Bankruptcy Code § 1102.
202. Bankruptcy Code § 1125(b), (c).
203. Bankruptcy Code § 1125(b), (c).
204. See, e.g., In re Martin, 113 B.R. 949, 962 (Bankr. N.D. Ill. 1990); In re Hirt, 7 B.R. 981 (Bankr. E.D. Wis. 1989) (both courts refusing to approve disclosure statement because cash flow projections were inadequate).
206. See infra part IV.B.4.c.
207. See LoPucki & Whitford, Corporate Governance, supra note 15, at 716.
208. See infra part IV.B.4.c.
only thirty days from the filing of the notice of intention to file a proposal.209 In both regimes, the courts entertain motions for short extension periods. A court will hold a hearing on each application for extension and consider, among other things, the progress of the case and the prospects for successful reorganization.210

E. Terminating Inappropriate Cases

In both the U.S. and Canadian regimes, monitoring often brings to light circumstances suggesting that a pending case is inappropriate for reorganization. The laws of both countries provide for an array of mechanisms to bring these circumstances to the attention of the court. Once a court has notice of such circumstances, it may shift decision-making authority from the debtor to an officer of the court, such as a trustee or an interim receiver.211 Particularly in the United States, this displacement is often an intermediate step that leads quickly to the termination of the reorganization effort and the liquidation of the debtor.212

In all three regimes, the court may terminate the formal reorganization process or convert it to a liquidation proceeding.213 Motions to terminate the reorganization case are more common under the CCAA than under the U.S. Bankruptcy Code. Because such motions sometimes occur within days of the initial CCAA order, they are discussed in the section on access to reorganization.214 The BIA provides statutory guidelines for the termination of reorganization cases, and we

209. BIA § 50.4(8).
210. BIA § 50.4(9).
211. See supra part III.D.1.
212. If a trustee is appointed in a U.S. reorganization, there is a substantial likelihood that the trustee will terminate the business operations or that the case will be converted to Chapter 7. See LoPucki, The Debtor in Full Control, Part 2, supra note 18, at 259–60 (nearly all trustees appointed in reorganization cases promptly moved to convert the reorganization cases to liquidation). The Chapter 7 trustee has the authority to operate the business and sell it as a going concern, Bankruptcy Code § 721, but the courts seldom convert cases in which sale as a going concern is appropriate, and trustees seldom attempt to sell businesses as a going concern. The principal function of an examiner is to investigate. Bankruptcy Code § 1106(b). The investigations frequently discover facts that constitute grounds for dismissal, conversion, or the appointment of a trustee. This statement may be less accurate in Canada where the displacement of management by the granting of decision-making power to a CCAA monitor or a BIA interim receiver appears to be more of a precautionary step than a signal of the demise of the debtor as a going concern.
213. In the United States, the court may dismiss the case or convert it to liquidation under Chapter 7 of the Bankruptcy Code. Bankruptcy Code § 1112(b). The CCAA court appears to have the same options. In contrast, the BIA provides that, upon termination, the debtor is deemed to have made an assignment in bankruptcy liquidation. BIA § 50.4(11). A debtor may also be liquidated in the United States by means of a creditor-proposed liquidating plan. See Bankruptcy Code § 1123(a)(5)(D). To propose such a plan, the creditors must first win the termination of exclusivity. See Bankruptcy Code § 1121(c).
214. See supra part II.C.
expect that the courts will use a similar approach to that developed under the CCAA. The laws of both countries focus on the same four factors:\(^\text{215}\) (1) whether the debtor is acting in good faith,\(^\text{216}\) (2) whether the reorganization is proceeding quickly enough,\(^\text{217}\) (3) whether the debtor appears to have the ability to reorganize,\(^\text{218}\) and (4) whether the debtor's reorganization effort is causing injury to creditors.\(^\text{219}\) In both countries, the courts have considerable discretion in determining what combination of factors warrants termination of the reorganization effort.\(^\text{220}\) Poor financial performance by the reorganizing debtor is not per se grounds for termination of the reorganization effort in either country.\(^\text{221}\) Persistent losses, however, are likely to lead to close scrutiny of both the quality of the debtor's management and the prospects for reorganization.

In all three reorganization regimes, a creditor may apply to the court for relief from the stay if the prospects for successful reorganization are slim. The lifting of the stay, particularly against a secured creditor with a substantial claim, can effectively end the reorganization attempt. There is, however, a difference in the degree to which the lifting of the stay serves this function in the two countries. Although motions to lift the stay are ostensibly designed to assure the protection of each

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\(^\text{215}\) The criteria used by the courts under the CCAA in deciding whether to terminate a case are discussed in part II.B.

\(^\text{216}\) Under U.S. law, most of these grounds are set forth in Bankruptcy Code § 1112(b)(3), (8) and (10). In addition, however, some courts recognize “bad faith filing” as a grounds for dismissal. \textit{E.g.}, \textit{In re Victory Construction Co.}, 42 B.R. 145 (Bankr. C.D. Cal. 1984). Under the BIA, lack of good faith is expressly recognized as grounds for refusing to extend the time for filing a proposal, BIA § 50.4(9), or terminating the time for filing a proposal, BIA § 50.4(11).

\(^\text{217}\) Under Chapter 11, “unreasonable delay that is prejudicial to creditors” is a factor the court can consider in deciding whether to convert or to dismiss the reorganization case. Bankruptcy Code § 1112(b)(3). Under the BIA, lack of “due diligence” is grounds for refusing to extend the time for filing a proposal, BIA § 50.4(9), or terminating the time for filing a proposal, BIA § 50.4(11).

\(^\text{218}\) Under Chapter 11, the debtor’s inability to reorganize is grounds for dismissal or conversion under Bankruptcy Code § 1112(b)(1), (2), (4), (5), and (7). Whether or not the debtor “would likely be able to make a viable proposal” if given more time is expressly recognized as grounds for refusing to extend the time for filing a proposal, BIA § 50.4(9), or terminating the time for filing a proposal, BIA § 50.4(11).

\(^\text{219}\) Chapter 11 recognizes “continuing loss to or elimination of the estate” and “unreasonable delay that is prejudicial to creditors” as factors to be considered by the court in deciding whether to convert or dismiss the case. Bankruptcy Code § 1112(b)(1), (2). Under the BIA, whether creditors would be “materially prejudiced” is expressly recognized as grounds for refusing to extend the time for filing a proposal, BIA § 50.4(9), or terminating the time for filing a proposal, BIA § 50.4(11).

\(^\text{220}\) See Bankruptcy Code § 1112(b); BIA § 50.4(9), (11).

\(^\text{221}\) See Bankruptcy Code § 1112(b)(1). There must also be an “absence of a reasonable likelihood of rehabilitation.” Note, however, that if the particular assets lost in operations are the collateral of a secured creditor and the debtor cannot provide adequate protection by substituting other collateral, the secured creditor is entitled to a lifting of the stay so it can repossess its collateral. Bankruptcy Code § 362(d)(1). See BIA § 50.4(9), (11).
secured creditor from injury resulting from decline in the value of its collateral during the case, such motions have probably become the principal means for terminating inappropriate cases under Chapter 11. Motions to lift the stay are far less often used for that purpose in cases under the CCAA, which suggests that they will be a relatively unimportant termination mechanism under the BIA as well.\(^2\) Under the CCAA and the BIA, the courts are more likely to address the problem directly by expressly terminating the reorganization effort.

The U.S. Bankruptcy Code provides for a lifting of the automatic stay if the debtor does not have equity in the collateral and if the collateral is not necessary to an effective reorganization.\(^2\)(d) The U.S. Supreme Court recently interpreted the latter phrase as requiring a reasonable possibility of successful reorganization within a reasonable time.\(^2\)(d) The effect of this decision is to give many secured creditors the ability to raise the issue of the reorganizability of the debtor on a motion to lift the stay. Although secured creditors could raise the same issue through a motion to dismiss or convert, they usually prefer to raise it by motion to lift the stay for several reasons. First, even an unsuccessful attempt to lift the stay triggers the secured creditors' rights to "adequate protection" of the value of their claims,\(^2\) which is not true of a motion to dismiss. Second, motions to lift the stay are entitled to priority on the court's calendar.\(^2\) Third, the law governing motions to lift the stay favors early determinations of the reorganizability of debtors,\(^2\) while the Code provision governing dismissal and conversion discourages early determinations.\(^2\)

\(^{222}\) The authority of the courts in Canada to lift the stay selectively is less directly related to the prospects for reorganization. The BIA authorizes the lifting of the stay when the affected creditor is likely to be materially affected by the stay or the relief is equitable on other grounds. BIA § 69.4.

\(^{223}\) Bankruptcy Code § 362(d).


What this requires is not merely a showing that if there is conceivably to be an effective reorganization, this property will be needed for it; but that the property is necessary for an effective reorganization that is in prospect. This means . . . that there must be "a reasonable possibility of a successful reorganization within a reasonable time." . . . [Even during the first four months of the case] lack of any realistic prospect of effective reorganization will require § 362(d)(2) relief.

\(^{225}\) See, e.g., In re Haibich, 63 B.R. 314 (Bankr. N.D. Ind. 1986) (right to adequate protection accrues only when creditor moves to lift the stay; it is not retroactive).

\(^{226}\) See Bankruptcy Code § 362(e) (stay is terminated 30 days after motion to lift, unless the court, after notice and a hearing, orders the stay continued; final hearing on motion to lift the stay must be commenced within 30 days after conclusion of the preliminary hearing).

\(^{227}\) See supra note 224.

\(^{228}\) For example, to constitute grounds for dismissal or conversion under Bankruptcy Code § 1112(b)(1), loss must be "continuing," and delay must be "unreasonable." The provision requiring "denial of confirmation of every proposed plan and denial of a request made for
By contrast, even without creditor action, the Canadian system routinely brings cases before the court for evaluation and possible termination. Under the CCAA, for example, the initial order specifies the time, typically only a few months, within which the debtor must present a reorganization plan and imposes the stay for that period only. To continue in reorganization beyond that time the debtor must file a plan or seek an extension from the court. Similarly, the BIA initially gives the debtor only thirty days within which to file a proposal. The debtor must then apply for extensions at intervals no longer than forty-five days. In considering these applications for extension, the courts can easily revisit the issue of whether the debtor remains an appropriate candidate for reorganization. As discussed above, the CCAA court makes decisions to extend on the basis of the same factors that govern its decision to terminate.

Despite similarities in the stated policies of the two countries, there appears to be a real difference in judicial attitude with regard to the termination of cases. We introduced this contrast in Part II with respect to the screening of cases in Canada and revisit it in the last section of Part IV on the negotiation of the reorganization plan. This difference in approach is demonstrated in two mechanisms used to terminate Canadian cases. First, Canadian doctrine not infrequently vests a single secured creditor or a small group of secured creditors with the formal power to block a reorganization.229 The creditor or creditors who appear to have this power may announce early in the case that no proposal will be acceptable to them. That announcement may prompt the court to terminate the reorganization case at that time, particularly if it believes that the debtor is not a viable going concern.230 Under U.S. law, by contrast, individual creditors or small groups of creditors rarely have even the apparent ability to block a reorganization.231

Second, Canadian law formally contemplates that the debtor will have only a single attempt at reorganization. Under the provisions of the BIA and sometimes under CCAA orders, if the debtor loses a

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additional time for filing another plan" suggests that the debtor is to be given every opportunity to reorganize before dismissal or conversion is appropriate. See Bankruptcy Code § 1112(b)(5).

229. See infra part IVB.2.c.

230. The courts have shown a willingness to give the creditor the opportunity to reorganize if they feel that the debtor is a viable going concern. See supra note 52 and accompanying text. In a recent case under the BIA, the court extended the statutory stay period upon finding that the debtor had an outline of its proposal and held that it was too early to find that the opposing creditor would not accept the proposal. Re High Street Construction Ltd., 1993 O.R. No. 394 (Ont. Ct. (Gen. Div.)).

creditor vote or a court hearing on approval of the plan, the debtor is automatically placed in liquidation.\(232\) This aspect of Canadian doctrine stands in interesting contrast to the U.S. provisions, under which plans can be modified\(233\) and the loss of a vote or a denial of confirmation can be followed by the proposal of an amended plan.\(234\) Even if a Chapter 11 case is dismissed, the dismissal will almost certainly be without prejudice, leaving the debtor free to continue its reorganization effort by filing another case.\(235\)

Canada’s “guillotine rule,”\(236\) as it has come to be called, is such harsh doctrine that its faithful implementation would be surprising. Rather, one would expect that, despite the rule, participants in the system would find ways of assuring that clearly desirable reorganizations continued. Our interviews with Canadian attorneys confirmed that expectation. Several means were used to get around the guillotine rule. In one case, for example, the parties feared that a particular plan proposed by the debtor would be voted down at the meeting of creditors, necessitating a liquidation that neither debtor nor creditors desired. The parties solved the problem by agreeing to take a “straw vote” before the actual vote. When the straw vote indicated that the plan would not receive a sufficient majority, the parties agreed to a temporary adjournment without an actual vote. The debtor used the adjournment as an opportunity to modify its proposed plan. Similarly, a Canadian court might indicate its intention to refuse approval of a particular plan, but not enter the order, giving the debtor the opportunity to return with a different plan. These liberalizing practices may cause the Canadian system to function in a manner not significantly different from the U.S. system, in which debtors are routinely permitted to amend their plans after losing votes or hearings.

\(232\) See BIA § 50.4(8) (where period for filing a proposal expires without one having been filed, debtor is deemed to have made an assignment); BIA § 57 (where the creditors refuse a proposal, the debtor is deemed to have made an assignment); BIA § 61(2) (where the court refuses to approve a proposal, the debtor is deemed to have made an assignment). Some CCAA orders have made similar provision. See, e.g., Order in Re Quintette Coal Ltd. (June 13, 1990), Vancouver A901507 at 7 (B.C.S.C.) (“On the event that the Reorganization Plan is not approved by the requisite majority... the Petitioner shall be adjudged hankrupt and a receiving order under the Bankruptcy Act... shall be deemed to have been made against the Petitioner.”).

\(233\) See Bankruptcy Code § 1127.


\(235\) Bankruptcy Code § 349. The U.S. courts are currently grappling with the problem of inappropriate cases that go into a seemingly endless loop of dismissal and re-filing. See LYNN M. LOPUCKI, STRATEGIES FOR CREDITORS, supra note 49, § 11.5.

\(236\) This term is from J.J. Quinn, Corporate Reorganization and Strategic Behaviour: An Economic Analysis of Canadian Insolvency Law and Recent Proposals for Reform, 23 OSGOODE HALL L.J. 1, 18 (1985).
IV. DETERMINING THE TERMS OF REORGANIZATION

A. Determining the Future of Business Operations

In order to attract support for their plan of reorganization, debtors may communicate their future business plans to creditors and other parties to the restructuring. It is unusual for a reorganization plan itself to restrict the debtor's future business decisions. Nevertheless, covenants in new private or public debt issued under the plan may restrict the debtor's actions. These covenants are typically described in the reorganization plan.

In both the United States and Canada, a reorganizing debtor may sell all or part of its business. Nevertheless, using the reorganization process to liquidate is controversial in two respects. First, the debtor may circumvent creditor protections which exist under the liquidation procedure, particularly the requirement that a disinterested trustee or receiver negotiate the terms of sale. Second, some debtors also attempt to circumvent creditor protections which exist under the plan confirmation process by selling their businesses without first seeking approval or confirmation of a plan.

Under the CCAA, the ability of a debtor to liquidate entirely pursuant to a plan of reorganization remains unresolved. Several CCAA orders, however, have permitted partial liquidation during a reorganization case, even without the formality of a plan. The BIA does not expressly address the issue, and there has been no decided case on point in that regime. Over a decade ago, the United States abandoned any attempt to distinguish liquidating from reorganizing debtors under Chapter 11. Such distinction appears to be impractical.

237. A reorganization plan is called a "proposal" under the BIA and a "compromise" or "arrangement" under the CCAA. For the sake of consistency, we call them all "reorganization plans."


239. See generally Associated Investors of Canada Ltd. (1987), 67 C.B.R.(N.S.) 237 at 245, rev'd on other grounds (1988), 71 C.B.R.(N.S.) 71. Justice Berger stating the CCAA may be used to liquidate a debtor if it yields benefits that are not available by liquidating under the Bankruptcy Act or the Winding-up Act; Philip's Manufacturing Ltd. v. Hong Kong Bank of Canada (1992), 69 B.C.R. No. 1933 (B.C.C.A.), Taylor, J.A. (CCAA stay terminated when debtor ceased to carry on business and started to liquidate because there was no evidence of benefits which would not be available by liquidating under another statute). The argument can also work the other way. See Re Perkins Holdings Ltd., [1991] O.J. No. 1000 (Ont. Ct. (Gen. Div.)), Chadwick, J. (declining to terminate the proceedings on the grounds that a receiver manager could not do anything the debtor could not do with the assistance of its financial advisers).

240. The initial orders in several cases permitted liquidation or downsizing, without requiring the approval of the creditors. See, e.g., Order in Re Graston-Faruq (Dec. 23, 1991), (Ont. Ct. (Gen. Div.)) [unreported]; Order in Re Ayre's Ltd. (Dec. 9, 1991), St. J. No. 4283 (Nfld. S.C.); Order in Re Silcorp Ltd. and 162969 Canada Inc. (June 11, 1992), File No. B15292 para. 7 (Ont. Ct. (Gen. Div.)).

241. Under U.S. law prior to 1978, liquidation by the debtor in possession was considered an improper motive for filing a reorganization case. If the debtor filed with the intention of
given that a large proportion of cases involve a combination of liquidation and reorganization. Under U.S. law, the debtor's right to liquidate pursuant to a confirmed plan or reorganization is clear. Indeed, a debtor need only show a "business justification" to liquidate during the case without observing the formalities of the plan process.

B. Determining the New Financial Structure

The objective of most reorganizations is to restructure the debt claims against, and the ownership interests in, the debtor such that the debtor will emerge from the process with only obligations it can meet. The debtor accomplishes the restructuring through the adoption of a plan that provides for the new structure. In both countries, the debtor's management usually drafts and files the plan or proposal. In both countries, the debtor may formulate the plan before filing for reorganization. In those cases, the purpose of filing is usually to bind dissenters and obtain legal sanction for the restructuring arrangement. In most cases, however, the debtor formulates the plan during the reorganization case, under the protection of the stay.

To prevent creditors or classes of creditors from overreaching, all three reorganization schemes provide mechanisms for binding dissenters to plans accepted by requisite majorities. To prevent debtors from overreaching, both countries give dissenting creditors substantive and

242. See LoPucki & Whitford, Patterns, supra note 18, at 605-06, 615 (demonstrating through empirical evidence that most large reorganizations are a combination of liquidation and reorganization, making attempts to permit one but not the other futile).

243. See Bankruptcy Code § 1123(a)(5)(D).

244. See, e.g., Committee of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983) (holding that debtor applying for permission to conduct sale pursuant to Bankruptcy Code § 363 without first obtaining confirmation of a plan lacked business justification).

245. Reorganization plans and proposals vary considerably in length and complexity. For the smallest companies, the plan may be only a few pages (the shortest confirmed plan seen by the authors was on a single page). For the largest, the plan may be a hundred pages or more. In the United States, large companies customarily combine the plan and disclosure statement in a single document and attach financial statements and other exhibits. The entire document is usually in excess of 200 pages.

246. Under the Bankruptcy Code, these cases are known as prepackaged plans. The CCAA expressly contemplates a formulated plan at the time of application. CCAA §§ 4, 5. See, e.g., Order in Re Ball Packaging Products Canada, Inc., [1991] O.J. No. 944 (Ont. Ct. (Gen. Div.)). Under the BIA, the process may be initiated by filing a proposal instead of a notice of intention. BIA § 50.

procedural rights through which to raise their objections in court. Finally, although debtors may be able to bind dissenters by legal means, numerous legal and extralegal forces encourage and facilitate negotiated restructurings in the shadow of formal rules. Hence, in both countries, a great deal of effort is directed at achieving consensus.

1. Focusing on a Particular Solution to the Restructuring Problem

A financial restructuring is often complex and involves numerous stakeholders. The outcome depends not only on the substantive rights of the parties, but also on the process through which the parties address the restructuring problem, the order in which issues are considered, and the particular alliances that form. For example, the proponent of a plan proposes not only the allocations to be made to the creditors and shareholders, but also the division of those creditors and shareholders into voting classes and the time at which the vote should take place. Just as politicians can change the outcomes of elections by gerrymandering voting districts, the proponent of a reorganization plan may be able to change the outcome of a vote on acceptance of a plan by gerrymandering classes of claims and interests. Such gerrymandering is just one of many ways in which the ability to determine when and how competing plans will be considered can affect the result.

The three reorganization regimes under comparison all have adopted the same fundamental scheme of agenda control. Generally speaking, in each regime, the debtor has the exclusive right to formally propose a comprehensive solution to the restructuring problem in the form of a written plan. The other parties to the proceeding, however, have the legal right to participate in formulating that plan or proposal and to request that the court terminate the debtor's exclusive right. As a matter of practice, the debtor typically drafts the plan in all three regimes; if it is a large company, the debtor will probably do so in consultation with creditor representatives.

These functional similarities overlay what is otherwise a bewildering array of doctrinal differences. Under Chapter 11, the debtor in possession has the exclusive right to file a plan during the first 120 days of the case (the "right of exclusivity"). The court may extend this period. Indeed, in the reorganizations of large companies it is not unusual for U.S. bankruptcy courts to extend the debtor's right of exclusivity for the duration of the case. Under the BIA, the debtor has the exclusive right to file a proposal unless control of the debtor's

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248. Bankruptcy Code § 1121(d).
249. See LoPucki & Whinston, "Choice and Shopping," slip no. 18, at 31 n.67 (exclusivity was lifted or expired in only nine of 45 cases that had a median length of two years); Bankruptcy Code § 1121.
property passes into the hands of a liquidator, a bankruptcy trustee, or a receiver. The text of the CCAA does not address the issue of who may file a proposal, and there is no doctrinal rule making the debtor's right to file a plan exclusive. But CCAA orders usually instruct the debtor to return before the court with a plan that can be voted on by the creditors before the conclusion of the period of the stay, reflecting an intention that the plan be prepared by the debtor. Creditors are not barred from either initiating CCAA proceedings or presenting their own reorganization plans, but both events are extremely rare.

Each of the three regimes gives persons other than the debtor the right to participate in the formulation of the plan. Chapter 11 provides official committees with such a right. The BIA provides trustees, who serve similar functions, with a virtually identical right. Most CCAA orders give the monitor the right to participate in the formulation of the plan, and some monitors have assumed lead roles in that regard.

Finally, each regime gives the court control over the duration of any exclusive right to file a plan that the debtor may have. Under U.S. law, exclusivity expires 120 days after the start of the case unless the debtor obtains extensions of that period from the court. The extensions granted are each typically short, compelling the debtor to return to court periodically to justify additional time. Canadian debtors under the BIA and the CCAA must do the same. Absent a functional analysis, however, it may seem that the extensions sought by U.S. and Canadian debtors are of a fundamentally different kind. When exclusivity expires in a Chapter 11 case, the debtor remains in reorganization, and any party in interest can file a plan. In contrast, when the court refuses to extend the debtor's time for filing a proposal in a BIA case, the debtor is deemed to have made an assignment, and the case is converted to liquidation.

Doctrinally, the deadlines debtors face under both Canadian laws are not merely deadlines for the expiration of exclusivity, but court-imposed deadlines for the filing of their plans. In context, however, the U.S. and Canadian systems of deadline and

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250. See BIA § 50(1). Creditor proposals were contemplated in previous drafts of the BIA, but were rejected. See Bill C-60 (1975).
251. But see, e.g., Order in Re Ball Packaging, [1991] O.J. No. 944 (Ont. Ct. (Gen. Div.) (proposal by a majority of secured creditors received the required votes of creditors and was approved by the court).
252. Bankruptcy Code § 1103(c).
253. BIA § 30.5.
254. See, e.g., Order in Re Silcorp Ltd. and 162969 Canada Inc. (June 11, 1992), File No. B152/92 para. 17 (Ont. Ct. (Gen. Div.).)
255. See supra note 248 and accompanying text.
256. Bankruptcy Code § 1121(c).
257. See, e.g., BIA § 50.408.
extension can be seen to serve the same function: that of limiting the debtor's period of control over the bargaining agenda. The consequence of failure to meet the deadline under either Canadian law is likely to be conversion of the case to liquidation. But as noted earlier, both creditors and courts will be slow to force the termination of the reorganization attempt of a viable debtor because the principal victims of such a termination might be the creditors themselves. More directly to the point, once the case is in liquidation, the liquidator or bankruptcy trustee has the right to file a proposal under the BIA. If either of them does so, the reorganization effort resumes. Thus, in context, the Canadian rule is not a limit on the filing of a plan, but only a limit on the debtor's right to file it.

2. Dealing with Dissenters to the Plan or Proposal

Reorganizing debtors typically have many creditors who, but for the stay, could obtain judgment against them, seize their assets, and perhaps bring the business to a close. A principal purpose of reorganization is to restructure the debtor's obligations so that the debtor can pay them all as they come due. As noted below, the Canadian and, to a somewhat lesser degree, the U.S. systems rely heavily on agreement by the creditors to accomplish the necessary restructuring. Yet, the agreement of all creditors necessary to the success of a reorganization is seldom a practical objective. To function effectively, a reorganization system must have some means to bind dissenting creditors to a plan that is acceptable to creditors generally, or to otherwise prevent them from interfering with the reorganized business.

The Canadian and U.S. systems employ three methods for dealing with dissenters. First, in both countries, a majority of creditors of a class voting in favor of a plan can bind the minority. Second, under U.S. law, but not under Canadian law, the court can impose a plan that is fair and equitable upon classes that have voted against it. Third, in both countries, the debtor can pay dissenting creditors in full if it has the consent of classes disadvantaged thereby.

a. Binding Dissenters by Classification and Voting

In both the Canadian and U.S. systems, a plan can divide creditors into classes. The majority of a class can bind the minority through voting. This method is of greater importance in the Canadian system.
because Canadian law provides few alternative means for binding dissenters to a plan. The theory underlying classification and voting in both countries is that each class should contain only creditors with essentially the same rights and, therefore, essentially the same interests and incentives to consent to a reduction in those rights. If the majority of a group of similarly situated creditors consents to the reduction, the reduction is presumed to be in the interests of the class and is imposed on all members, not just those voting in favor of the plan. 260

Both countries permit the debtor to bind creditors (claims) and shareholders (interests) through the technique of classification and voting. In both countries, a class of interests is deemed to have accepted a plan if the plan receives approval from at least two-thirds of the votes cast. 261 In the United States and under the BIA, a class of claims accepts the plan if the plan receives the votes of at least two-thirds in amount and more than half in number of the allowed claims in the class that are actually voted. 262 Under the CCAA, the required majority with respect to the amount of claims is three-fourths. 263 In both countries, the courts appear to have the authority to disregard votes that are not cast in good faith. 264

The fairness of the voting process rests ultimately on the fairness of the scheme of classification. In both the United States and Canada, the debtor ordinarily drafts the plan, classifying claims and interests in the process. 265 Creditors have the right to challenge the proposed classification by application to the court. 266 While U.S. and Canadian authori-

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260. The theory contemplates that the reduction is usually, but not always, the quid pro quo for reductions in competing claims against the debtor's limited assets.

261. In Canada, the acceptance by shareholders is governed under corporation statutes. CCAA § 20. See, e.g., Ontario Business Corporations Act, R.S.O. 1990, c. B-16 as amended, § 182; Olympia & York Developments Ltd. v. Royal Trust Co. (1993), 18 C.B.R. (3d) 176 (Ont. Ct. (Gen. Div.)). The U.S. Bankruptcy Code provision governing the vote of shareholders is somewhat redundant since majorities of shareholders usually have the ability to bind minorities through voting under corporate law.

262. For example, assume that seven creditors hold claims in a particular class and that the claims total $1 million. Two of the creditors, holding claims totaling $50,000 in amount, vote in favor of the plan. One creditor, holding a claim in the amount of $20,000, votes against the plan. The holders of the remaining claims do not vote. The class has accepted the plan. They accepted by five-sevenths in amount ($50,000 divided by the $70,000 of claims voting) and by two-thirds in number.

263. CCAA § 6. The difference between the voting majority required under the CCAA and under the BIA or Bankruptcy Code may be offset by the fact that the latter two statutes have classification rules that lead to smaller classes. See infra part IV.B.2.b.


265. Bankruptcy Code § 1123(a)(1); BIA § 501(1), (1.2).

266. BIA § 501(1.5) (court may determine classification of secured claims on application made at any time after the notice of intention). Under U.S. procedure, any creditor can challenge the appropriateness of classification by objecting to the plan. See, e.g., In re Greystone III Joint Venture, 102 B.R. 560 (Bankr. W.D. Tex. 1989).
ties are in general agreement that similar claims, and only similar claims, should be classed together for purposes of voting, the notion of similarity is subject to a variety of interpretations and is ultimately a matter of degree. The basic underlying principle is that voters should share a common interest in the treatment the class receives. We will discuss classification of secured and unsecured claims separately, because the considerations are different. The rules with respect to secured creditors differ significantly between the two countries, reflecting the different functions served by classification in Canada and the United States.

Classification of unsecured claims in both the U.S. and Canadian regimes involves many of the same rules and issues. The principal issues are first, whether all must be placed in the same class and second, whether all may be placed in the same class. The BIA expressly authorizes, but does not require, the debtor to put all unsecured claims in a single class. The CCAA contemplates single or multiple unsecured classes. Recent cases have required debtors to place landlords in separate unsecured classes because they would enjoy preferred claims in bankruptcy liquidation. United States law requires that each claim be substantially similar to the other claims or interests in its class. Though it does not expressly require that substantially similar claims be placed in the same class, some U.S. courts hold that aside from the statutory exception authorizing a separate class of small unsecured claims for administrative convenience, all unsecured claims of a given priority must be in the same class. Other U.S. courts permit multiple classes of unsecured claims based on a variety of distinctions. Thus, while neither country has settled on a single solution to the problem of classifying unsecured claims, the range of solutions employed in the two countries is narrow.

267. The principal issue is the degree to which inquiry should be confined to the legal rights of the creditor or expanded to examine whether the holders of the claims can be expected to have similar motives in casting their votes. For example, cases have arisen in the United States over whether an unsecured creditor can be classed together with another creditor whose principal motive in casting its vote will be to enhance its position as an owner of the debtor, In re Martin's Point Ltd. Partnership, 12 B.R. 721 (Bankr. N.D. Ga. 1981) (holding the ownership motive not relevant to classification of the creditor's claim), or who will be motivated by a difference in the effect the plan would have on its own liability for income taxes, In re Nite Lite Inns, 17 B.R. 367 (Bankr. S.D. Cal. 1982) (holding different tax implications not relevant to classification).

268. BIA §§ 50(1.2), 54(2)(b)(i).

269. CCAA § 4.

270. See supra part III.B.2.

271. Bankruptcy Code § 1122(a).

272. Bankruptcy Code § 1122(a). The amounts used range from approximately $250 to $5,000, depending principally on the size of the case in which the class is created.

273. Probably the principal reason for creating multiple classes of claims in U.S. reorganizations is to satisfy the requirement that there be at least one class of impaired claims voting in favor of the plan. See Bankruptcy Code § 1129(a)(10).
The rules for classification of secured claims are materially different between the two countries. The principal doctrinal issue is whether a difference in collateral or priority is itself sufficient to require separate classification. United States courts interpret the "substantially similar" test to permit secured claims to be classified together only if they have the same priority against the same collateral.274 Since secured creditors seldom share the same priority against the same collateral, the effect is usually to entitle each secured claim to be alone in its class and, therefore, to control the vote of its class.

Under the CCAA, the courts have struggled with the issue of classification of secured claims. Some courts have applied an identity of interest test that is essentially the same as the U.S. rule.275 Nevertheless, the majority of courts have allowed, to varying degrees, placement of secured creditors in the same class, even though they are secured by different collateral or have different priority against the same collateral.276 These courts require only that the members of a class have a "commonality of interest."277 The BIA provides for application of a "commonality of interest" test.278 That suggests that the courts should follow the majority rule under the CCAA in allowing debtors to place secured creditors with varying priorities in different collateral in the same class for the purpose of voting.279 Adoption of the commonality of interest test under the BIA will move Canadian classification doctrine further from U.S. classification doctrine.

274. E.g., In re Holthoff, 58 B.R. 216, 219 (Bankr. E.D. Ark. 1985) ("Secured creditors with liens in different property or liens in the same property but with different priorities may not be classified together since their legal rights are not substantially similar.").


276. E.g., Re Fairview Industries Ltd. (1991), 109 N.S.R. (2d) 32 (N.S.S.C.) (the commonality of interest test refers to legal interest, or priority, rather than commercial interest, such as whether a security interest is in quick assets or fixed assets); Northland Properties Ltd. v. Excelsior Life Ins. Co. of Canada (1989), 73 C.B.R.(N.S.) 195 (B.C.C.A.); Norcen Energy Resources Ltd. v. Oakwood Petroleum Ltd. (1988), 72 C.B.R.(N.S.) 20 (Alta. Q.B.).

277. Many courts cite the test in Sovereign Life Assurance Co. v. Dodd, [1892] 2 Q.B. 573 at 583 (C.A.); a class "must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest." E.g., Savage v. Amoco Acquisition Co. (1988), 68 C.B.R.(N.S.) 154 (Alta. C.A.). See also cases cited in supra note 276.

278. BIA § 50(1.4).

279. Nevertheless, the BIA § 50(1.4) lists four factors that may be taken into account: (1) the nature of the debts giving rise to the claims, (2) the nature and priority of the security, (3) the remedies available to the creditors in the absence of the proposal and the likely recovery from exercise of those remedies, and (4) the treatment of the claims under the proposal. The factors suggest that classification should be based on a comparison of the treatment of creditors under the plan and their likely recovery in liquidation. This is a stricter test than the CCAA commonality of interest requirement.

Justice Farley has suggested that the guidelines in the BIA will lead the courts to adopt a different approach under the BIA than under the CCAA. The Honourable Mr. Justice James Farley, "Potpourri of Current Topics," (Address to the Third National Institute on Multinational Commercial Insolvency, Toronto, May 13, 1993). There is yet another possibility that the courts
At a systems level, however, broad secured creditor classes compensate for other differences and enable the Canadian reorganization system to function more like that of the United States. As we discuss in the next subsection, U.S. law entitles the debtor to "cram down" a fair and equitable plan against dissenting classes of secured creditors. Therefore, the separate classification of a secured claim in the United States does not give the secured creditor a veto power over the plan; it merely entitles the creditor to a hearing on whether the plan is fair and equitable. Given the absence of cram down in Canada, the separate classification of individual secured claims would have given secured creditors veto power over reorganization. Thus, the flexibility of Canadian classification doctrine compensates for the lack of cram down in Canadian law.

b. Binding Dissenting Creditors by Judicial Determination

As we noted in the preceding section, the cram down provisions of Chapter 11 give U.S. bankruptcy courts the power to bind classes of secured creditors to a plan they have voted against. That power also extends to dissenting classes of unsecured creditors and shareholders. The beneficial effect is that no class of creditors or shareholders can prevent confirmation of a plan that is in the collective interests of all creditors and shareholders.

The court is authorized to impose only a plan that is "fair and equitable," which means, essentially, that the plan must propose distributions strictly in accordance with the absolute priority rule. That rule requires that the legal and contractual priorities existing among claims and ownership interests in the absence of reorganization must be preserved under the plan. The general nature of those priorities is most easily illustrated with regard to the rights of unsecured creditors and shareholders. In the absence of bankruptcy, unsecured creditors would have "absolute priority" over shareholders in the sense that shareholders would be entitled to nothing unless the unsecured creditors were paid in full. Thus, for a plan to be crammed down on a rejecting class of unsecured creditors, the plan must either provide for full payment to the unsecured creditors or no distribution to the shareholders. Similarly, the absolute priority rule requires that a

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may adopt the approach of the BIA in determining classification issues under the CCAA. See Re Woodward's Limited (1993), 20 C.B.R. (3d) 74 (B.C.S.C.) (comparing the treatment of creditors in the plan to their likely recovery in liquidation).


281. Two manifestations of the absolute priority rule are in the rules of corporate law that (1) an insolvent company cannot pay dividends and (2) the assets of a dissolved company must be distributed first to creditors, until they have been paid in full, and only then to shareholders.

secured creditor whose collateral is worth at least the amount of its claim must be offered payment in full under the plan of reorganization. Finally, it should be noted that claims or interests that are “under water,” in the sense that they are subordinate in right to other claims or interests that exceed the entire value of the company, can be extinguished without compensation through cram down.

Canada has rejected the concept of cram down. Canadian law contains no mechanism by which a plan may be imposed on a class that has voted against it. A legislative bill that preceded the current BIA, Bill C-17, authorized the court to formulate proposals and, after taking into consideration the interests of all affected parties, impose them on the classes of claims. The bill would have granted this cram down authority in cases where the debtor’s debts exceeded one million dollars. Under the bill, a court could even have departed from the absolute priority rule where doing so would have been just and equitable to the creditors generally. The proposal came under academic and professional criticism and was abandoned in the next set of proposed amendments.

The absence of a cram down in the Canadian system only matters for our comparative purposes where a class refuses to accept a plan that is in accord with the absolute priority rule or considers doing so. Canadian practitioners repeatedly told us that this rarely occurred in Canada. Even in the worst-case scenario, where junior claims or interests are clearly under water, the holders of those claims or interests are persuaded to accept a small distribution in many instances by the threat that deadlock would force a liquidation in which they would get nothing. Canadian lawyers also cited economic and cultural forces that promoted cooperation among creditors in Canada. While the substantial degree of repeat play and cooperative behavior in Canada

283. See Bankruptcy Code § 1129(b)(2)(A).
285. The reorganization plan of Olympia and York Developments Ltd. was sanctioned despite the fact that eight classes did not vote to accept it. The reason was that the plan specifically provided that classes that did not approve were not bound by the plan’s provisions. So, for instance, secured creditors would be entitled to realize their security any time after the consummation of the plan. Olympia & York Developments Ltd. v. Royal Trust Co. (1993), 17 C.B.R. (3d) 1 (Ont. Ct. Gen. Div.). The effect of the plan, however, was to exclude those classes from the reorganization. See infra note 299 and accompanying text.
286. See, e.g., Quinn, supra note 236, 29–30.
287. See Report of the Advisory Committee on Bankruptcy and Insolvency, supra note 112, at 58 (reporting concerns about the cost of this mechanism, the competency of judges in making these determinations, and the possibility that they may be swayed by social policy reasons to formulate plans that preserve entities that are not economically viable).
288. This is not to say that deals are always made. The Canadian legal community was recently shocked when a single shareholder and former vice-chairman of a CCAA debtor decided at the last minute to vote against a plan, thereby forcing the firm into liquidation. See Paul Brent &
ada seems to have rendered the weakness of Canada's legal mechanisms for dealing with dissenting classes less troublesome, we anticipate that if economic and cultural restraints break down, the Canadian system will develop substitute mechanisms.

The Canadian system already has some mechanisms for binding dissenting classes of shareholders and unsecured creditors. Consider, for example, a debtor with assets worth 100 as a going concern, but worth only 55 in liquidation.289 Further, assume that the debtor owes secured debt of 60 and unsecured debt of 90, for total debt of 150. The shareholders are under water, and would be entitled to nothing if the absolute priority rule could be brought to bear. Yet, suppose that the shareholders' final bargaining position is that the unsecured creditors must accept five in full settlement of claims so that shareholders can retain stock worth 35. They threaten to vote against any plan that gives more to the firm's creditors.

In the U.S. system, the creditors' remedy would be to obtain a termination of exclusivity and to propose a plan that extinguished the rights of shareholders. The court would be obligated to impose the plan by cram down.290 The general priority scheme of Canadian corporate and bankruptcy law is the same as that of the United States—creditors are entitled to absolute priority over shareholders.291 Nevertheless, the reorganization statutes in Canada do not authorize the court to vindicate this priority in a reorganization through the exercise of a cram down.

Not surprisingly, however, there are other doctrinal structures that can be brought to bear. With regard to a complete cram down against shareholders in which they are given no value, the doctrinal path is relatively direct. Neither the CCAA nor the BIA expressly provides for a vote of shareholders on a plan of reorganization. In the Canadian system, the vote of shareholders is taken, if at all, pursuant to provisions of general corporate law. The statutory provisions that authorize

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Richard Siklos, Peoples Jewellers Declared Bankrupt, Fin. Post, July 30, 1993, at 1. Given that the shareholder would receive nothing in liquidation, Justice Houlden, who presided over the case, commented, "It's unbelievable this has happened." Id. Two days later, the firm was sold as a going concern to a management-led group. The $77 million purchase price was less than the amount of the secured debt, with the result that neither the holders of $81 million in unsecured claims nor the owners of the company were expected to receive anything. Those groups were to own 15.8% of the company under the plan defeated by the shareholder's vote. See Paul Brent, Failed Peoples Sold for $77M, Fin. Post, July 31-Aug. 2, 1995, at 1.

289. In part I, we identified the existence of excesses of going concern value over liquidation value as one of the basic assumptions on which the reorganization systems of the United States and Canada are founded. See supra note 21 and accompanying text.

290. Bankruptcy Code § 1129(b).

291. See, e.g., Canada Business Corporations Act, R.S.C. 1990, c. B-16, § 38(3) (a corporation cannot declare or pay dividends if there are reasonable grounds for believing the firm is insolvent).
the vote empower the court to order that no vote be held.\textsuperscript{292} In one highly visible Canadian restructuring in which the corporation had not filed under either the BIA or the CCAA, the court expressed the view that shareholders who would receive nothing in liquidation should not be able to prevent the restructuring through voting, and accordingly denied shareholders the right to vote on a plan that extinguished their interests.\textsuperscript{293} The effect was precisely the same as if the court had ordered a cram down. While there is no similar authority in cases under the BIA or CCAA, we see no reason why the debtor’s filing under either law should change the result.\textsuperscript{294}

The preceding paragraph illustrates how the Canadian system replicates the function of the cram down against shareholders whose interests are under water, such as the shareholders in the example. It is more difficult to discern in Canadian reorganization law the functional equivalent of the cram down against a dissenting class of unsecured creditors whose claims are only partly under water. The U.S. cram down doctrine can be used to impose on dissenting unsecured creditors a plan that extinguishes the rights of shareholders and converts their unsecured debt into stock.\textsuperscript{295} In Canada, the secured creditors in our example might be able to compel the unsecured creditors to accept 40 in full settlement of their claims if the firm can be sold as a going concern; but they are unlikely to be able to force them to accept it in the form of stock. To accomplish the former result, the secured creditors would begin by forcing the debtor into liquidation. The trustee could then put the business up for sale as a going concern, subject to the claims of secured creditors. If a buyer emerges, perhaps one of the secured creditors, the purchase price would likely be a sum less than 40, which the trustee would distribute to the unsecured creditors, thereby discharging their claims. Given our underlying premise that

\textsuperscript{292} For example, the Ontario Business Corporations Act provides that “[t]he court may make an order approving the arrangement as proposed by the corporation or as amended in any manner the court may direct, subject to compliance with such terms and conditions, if any, as the court thinks fit.” OBCA § 182(5)(d) (emphasis added).


\textsuperscript{294} This result is somewhat easier to reach under the BIA. General corporate law in Canada provides that a vote of the shareholders is not required to effect a restructuring that has been approved by the court under the BIA. See, e.g., OBCA §§ 168, 186(2); CBCA § 191(1). The BIA itself provides only for voting by creditors and does not expressly grant shareholders the right to vote. BIA §§ 53–54. Under a reasonable interpretation of these provisions, shareholders are not entitled to vote on a plan of reorganization and can block the plan only by persuading the court that it is not reasonable. BIA § 50(2). There remains the question of how a plan that provides no recovery for shareholders would be proposed under the BIA. The answer may be that unsecured creditors may be able to force the debtor into liquidation. When that occurs, the bankruptcy trustee can file the proposal. BIA § 50(1).

\textsuperscript{295} See Bankruptcy Code § 1129(b)(2)(B).
the shape of reorganization law is driven by its function, we would not be surprised to see the Canadian courts take the next step and compel unsecured creditors to accept even a stock distribution in an extreme case; to date, however, we see no doctrinal route to that result.

The analysis we present here may also help to explain another important difference between U.S. and Canadian reorganization law. It is much more difficult to force conversion of a case to liquidation under U.S. than Canadian reorganization law. Our functional approach to reorganization leads us to suspect that easy conversion in Canada may have developed at least in part to facilitate scenarios such as the ones we present here and thus to compensate for the absence of a direct cram down.296

c. Paying Dissenting Creditors in Full

If a creditor will not agree to a reduction in the amount of its debt and the debtor cannot bind that creditor either through classification and voting or by judicial cram down, the debtor’s remaining option is to pay the dissenter the full amount of its claim. Both the United States and Canada allow the debtor to pay in full a dissenting class of creditors. But in recognition of the fact that full payment to one class of creditors reduces the payment to other classes, both countries give other classes the ability to block the payment.

Chapter 11 provides explicitly for the option to pay a class of creditors in full. If the plan provides that members in a class of creditors will be fully paid in cash upon confirmation, that class is deemed to be unimpaired and is automatically bound by the plan.297 The proposal to pay a class of creditors in full is part of the plan and therefore must be accepted by the classes of creditors whose claims are compromised.

The Canadian regimes allow for a similar result through a different mechanism. While Chapter 11 requires that a plan provide a comprehensive solution to the debtor’s financial distress,298 both Canadian regimes allow the debtor to direct its proposal at some classes of creditors, while excluding other classes.299 The effect of excluding a

296. With respect to junior claimants, the Canadian “guillotine” rule, enumerated in BIA § 57, may serve as a disciplinary mechanism. See supra note 236 and accompanying text. Unsecured creditor classes know that if they vote against the plan, the debtor will probably not get a second chance, but instead will be moved into straight bankruptcy proceedings. See generally Jacob S. Ziegel, The New Personal Property Security Regime: Have We Gone Too Far?, 28 ALTA. L. REV. 739 (1990) (addressing the disadvantaged position of creditors and suggesting possible remedies).
297. Bankruptcy Code § 1126(0.)
298. See Bankruptcy Code § 1129(a)(8), (g).
299. While the CCAA allows exclusion of either unsecured or secured classes, the BIA seems to allow exclusion of only secured classes. The BIA provides that the proposal must be made to
class of creditors from the plan is that, once the plan is approved and the stay terminated, members of the class can enforce the full amounts of their claims against the debtor. At that time, the debtor's only means for dealing with the claims may be to pay them in full. 300

Like its U.S. counterpart, an excluded class does not vote on the plan and therefore cannot block its acceptance. While other classes do not vote on the precise treatment of the excluded class, they do vote on the plan which provides for the exclusion. If they vote against it, they prevent the debtor from paying the excluded creditors in full, just as if the proposal to pay in full were expressly provided for in the plan. Thus we think that the two systems reach the same result: the debtor has the right to pay in full, but only on approval and confirmation of a plan that permits it.

The U.S. regime gives a reorganizing debtor the right to reverse acceleration of and to reinstate a payment schedule that existed under its pre-petition agreement with a class of its creditors. The debtor does so as part of the plan, by curing any default and compensating the creditors for damages caused by the default. 301 The Canadian regimes do not provide the debtor with a corresponding right. Although the Canadian debtor may be able to negotiate a reinstatement or a new agreement with an excluded secured creditor, it has no legal right to reinstate once there has been an event of default and acceleration under the agreement.

This difference between the U.S. and Canadian regimes can certainly be important once the debt is in default, particularly if the terms of repayment are advantageous to the debtor 302 or the debtor does not have the ability to pay the accelerated debt. 303 But in most cases, the
impact of this difference will be felt by the debtor in its decision on whether to allow the debt to go into default. In the United States, debtors freely default on long-term installment debts before or during reorganization with the intention of reinstating by curing the default at confirmation. In Canada, debtors must make the payments on long-term installment debt that they cannot refinance in the marketplace and wish to preserve.\footnote{304}

3. Protecting Dissenting Creditors

Unless it has mechanisms for protecting dissenting creditors, a reorganization process that binds dissenting creditors through classification and voting will be vulnerable to abuse.\footnote{305} Two categories of dissenting creditors should be distinguished: those who are dissenting along with other members of their class and those who are dissenting from the vote of their class.

Both the U.S. and Canadian systems protect dissenting \textit{classes of creditors} from overreaching by the debtor or other classes,\footnote{306} but by different means. In Canada, the protection flows from the rule that a plan cannot bind a class that has not voted in favor of it. In the United States, the opposite is true: a plan can be crammed down on a class that has voted against it. Nevertheless, a court can do so only on a finding that the plan is fair and equitable to the class and does not discriminate against the class unfairly.\footnote{307}

Both systems protect dissenting \textit{creditors within a class} from overreaching by the debtor in cooperation with other members of their own class. The rationale for permitting majorities to bind minorities through classification and voting assumes that the creditors in a particular class have the same interests. To ensure that this is the case, all three systems provide for judicial review of the fairness of the classification.

\footnote{304. The BIA does bar creditors from accelerating the obligations owing to them merely on the ground that the debtor is insolvent or has filed a notice of intention or a proposal, even if their contract purports to provide them that right. BIA § 65.1(1). A creditor who is otherwise receiving performance in accord with the contract can seek no remedy against the debtor.}

\footnote{305. Scholars in both Canada and the United States have commented on the difficulty in achieving the appropriate balance between the objectives of binding dissenters and preventing the imposition of an inequitable plan on them. \textit{See}, e.g., Quinn, \textit{supra} note 236; John C. Coffee & William A. Klein, \textit{Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations}, 58 U. CHI. L. REV. 1207 (1991).}

\footnote{306. Under Chapter 11 or the CCAA, competing classes might overreach by proposing a plan that gives them favorable treatment; under any of the three reorganization laws, competing classes might overreach by pressuring the debtor for such favorable treatment.}

\footnote{307. \textit{See supra} notes 280–284 and accompanying text.}
tion scheme specified; any creditor can challenge the scheme of classification by timely objection.308

Despite this provision, none of the systems can ensure that only creditors with like interests will be placed in the same class. The motives and characteristics of creditors are simply too diverse. To give but a few examples, there may be one creditor in the unsecured class who votes for the plan because he or she is a personal friend of the debtor, another creditor who votes for the plan because he or she is a supplier that hopes to profit by continuing to deal with the surviving business, and a third who votes for the plan because he or she also holds shares in the company and the plan is generous to shareholders. To create a separate class for every creditor having different motivations would defeat the purpose of classification and voting. Yet, for the mechanism of classification and voting to have legitimacy, the classification scheme must strike a reasonable balance between the need to bind dissenters through classification and voting and the need to protect dissenters from domination by creditors who have different interests.

Recognizing the subjectivity of the process of classification and voting, all three reorganization regimes place limits on the rights that can be waived by that process. Despite the contrary vote of the class in which it is appropriately placed, an individual creditor is entitled to object to approval of the plan on several grounds. For example, U.S. law requires that the value of property given by the plan to each creditor and shareholder must not be less than the distribution the creditor or shareholder would receive if the debtor were liquidated under Chapter 7 (the "best interests of creditors test"). This right can be waived only by the individual creditor or shareholder affected, not by vote of the class.309 While this test has been judicially recognized in cases under the CCAA, it does not appear to have been applied yet.310 The BIA does not expressly mention the test, but does permit any creditor to object to court approval of the plan on the ground that it is unreasonable or not calculated to benefit the general body of creditors.311 The courts under all three regimes seem to share the same

308. E.g., BIA § 50(1.5).
310. See, e.g., Stanley E. Edwards, Reorganizations under the Companies' Creditors Arrangement Act, 25 CAN. BAR. REV. 587, 595 (1947); Re Campeau (1992), 10 C.B.R. (3d) 104 (Farley, J., doubted factual basis for creditor's argument that it had received less under the plan than it would have received in liquidation); Re Plan of Arrangement of Olympia & York Developments Ltd., [1993] O.J. No. 545 (Blair, J., noted that the plan ensured that the parties would receive more than they would in liquidation).
311. BIA § 59(2). See also CCAA § 6; BIA §§ 59(1), 60(5). Under the BIA, the court will also hear the trustee's report on the terms of the proposal.
general concerns—the plan must be fair and reasonable, economi-
cally feasible, and calculated to be in the best interests of all par-
ties.

In both the United States and Canada, the consequences of court
rejection of a plan may also deter proponents from proposing plans
that treat dissenters unreasonably. Under the BIA and in many cases
under the CCAA, if the court fails to approve the proposal following
a successful vote, the debtor is deemed to have made an assignment in
bankruptcy, which initiates liquidation proceedings. Fear of this
"guillotine" makes it difficult for Canadian debtors to explore the
limits of what the courts will consider reasonable treatment of dissent­
ers, and encourages them to seek the agreement of all parties. Under
Chapter 11, the consequences of court failure to confirm a plan are far
less severe. The court probably will give the proponent leave to amend
the plan. Amendment is likely to lead to a delay of four or five months
while the debtor redrafts and seeks approval of the amended plan. For
a few U.S. debtors, such a delay in emerging from bankruptcy may
cause problems and thus encourages them to present an acceptable plan
at the outset. For others, however, the delay is welcome, perhaps giving
them incentives to test the limits of what courts will tolerate in the
treatment of dissenters.

4. Seeking Consensus

In both countries, considerable effort is devoted to building a con­
sensus on the terms of the plan. This is particularly true in large
reorganization cases. A consensual plan negotiated in the shadow of
the formal rules presumably reduces uncertainty and the expense of

\[312\] Thus, for example, a creditor who is ouvoted under the CCAA can nevertheless object
to the sanctioning of the proposal by the court on the ground that it is unfair or inequitable. See
Re Fairview Industries, [1991] N.S.J. No. 455 (N.S.S.C.T.D.) (court will deal with unfairness or
inequity at time of court sanction hearing). See also Northland Properties Ltd. (1988), 73 C.B.R. (N.S.)
175 (B.C.S.C.); Re Campeau Corp. (1991), 86 D.L.R. (4th) 570 (Ont. Ct. (Gen. Div.)); Re
Dairy Corp. of Canada Ltd., [1934] O.R. 436 (Ont. C.A.); Re Olympia & York Developments
Ltd., [1993] O.J. No. 545 (one measure of fair and reasonable is the degree of approval among
creditors); Re Central Guarantee Trust (1993), 21 C.B.R. (3d) 139 (Ont. Ct. (Gen. Div.)) (majority
consisted of sophisticated creditors); BIA § 59(2).

\[313\] Chapter 11 requires, as a condition of confirmation, proof that confirmation "is not likely to
be followed by the liquidation, or the need for further financial reorganization, of the debtor
or any successor to the debtor under the plan, unless such liquidation or reorganization is
proposed in the plan." Bankruptcy Code § 1129(a)(11). Under the CCAA, see Re 229531 B.C.
[1993] O.J. No. 545 (feasibility is part of the fair and reasonable requirement); BIA § 59(3).


\[315\] BIA § 61(2)(a). For examples of decisions under the CCAA, see Order in Re Quintette
Coal Ltd. (June 13, 1990), File No. A901507 (B.C.S.C.) and, generally, discussion in Re North­

\[316\] See infra part IV.B.A.4.a.
judicial determination. Moreover, it provides flexibility that cannot be achieved through adjudicated solutions. In large cases, the systems of both countries facilitate negotiations by providing for representation of stakeholders by committees. Finally, recognizing the unfortunate effects of the passage of time on the process of reorganization, both systems seek to limit the time debtors can remain in reorganization, although Canada does so more aggressively.

a. Providing Incentives for Negotiation

Neither Canadian nor U.S. law requires that the parties negotiate the terms of the plan, but both encourage it. In both systems, negotiation is pervasive, particularly in large cases. The Canadian system seems to rely more heavily on negotiation than the U.S. system; as discussed above, the Canadian system has somewhat less ability to bind dissenting creditors, leaving debtors in some cases with no option but to negotiate a solution.

In the United States, some judges encourage negotiations by conditioning extensions of exclusivity on progress in negotiations and by refusing to authorize the full payment of professional fees when progress is slow. Similarly, in Canada, the courts often require evidence of negotiating progress before granting extensions in the stay or denying creditor motions to terminate proceedings. In addition, CCAA orders sometimes expressly require monitors to coordinate negotiations and report to the court on progress achieved in this regard.

There are other legal, economic, and cultural forces that promote consensual reorganizations. For example, the measures necessary to bind and protect dissenters through classification and voting, cram down, or other judicially enforced limitations may require expensive litigation. Particularly in the United States, the expense is likely to fall disproportionately on the estate and ultimately on creditors. In some cases, the delay, uncertainty, and expense associated with controversy may threaten the viability of the debtor’s business. Since delays are usually more harmful to creditors than to debtors, the debtor can use the threat of delay to persuade creditors to agree to a negotiated distribution to under water shareholders, even though those shareholders would be entitled to nothing in a cram down hearing. Another

317. An exception in Canada is the reorganization of Algoma Steel under the CCAA, in which Justice Farley ordered the parties to submit to mediation to resolve their differences. See Farley, supra note 279, at 9-12. Bankruptcy Code § 1103(c) provides that an official committee may “participate in the formulation of a plan.”

318. In smaller cases, there are fewer parties and committees are rare. As a result, the U.S. debtor may be more inclined to rely on cram down than on negotiated consent. In Canada, there appears to be negotiation even in smaller cases where there are few or no committees. The difference may be due to the absence of the interclass cram down in Canada.

319. See LoPucki & Whitford, Bargaining Over Equity’s Share, supra note 18, at 147.
context in which a negotiated solution might be preferred is a small business whose going concern value depends on the expertise of its owner-manager. This owner might seek to trade her future participation in the enterprise for a continuing share in the ownership of the business. It is difficult under current law to effect this arrangement purely by adjudication. In the United States, a plan that permitted the owner-manager to retain a share of the firm would violate the unsecured creditors' right to "absolute priority" over shareholders and could not be crammed down.320 The parties may be able to preserve the manager's participation only in a negotiated solution.

b. Providing Representation for Creditors and Shareholders

In a large reorganization case, the dispersion and number of creditors and shareholders precludes direct negotiations among all of them. The mere solicitation of their preferences and opinions may be prohibitively expensive.321 The solution in both Canada and the United States is to establish committees to represent large classes of creditors. Because many creditors and shareholders cast their votes on the plan in accord with the committees' recommendations, the proponent of a plan cannot be confident of winning the vote of a class unless it first wins the recommendation of the committee representing the class. As a result, committees play an important role in the negotiation and voting process in both countries.322

The U.S. Bankruptcy Code specifically provides for the establishment and financing of committees. The Code requires that an unsecured creditors' committee be appointed in every case.323 The unsecured creditors' committee generally consists of the persons that hold the seven largest claims against the debtor.324 The court may also, if necessary to assure adequate representation, order the appointment of additional committees to represent creditors or equity security holders.

320. Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988); Bankruptcy Code § 1129(b)(2)(B); In re Landau Boat Co., 8 B.R. 436 (Bankr. W.D. Mo. 1981) (denying confirmation of a plan that violated the absolute priority rule). Perhaps not surprisingly, Chapter 11 provides a somewhat circuitous mechanism for forcing such a plan on creditors. The debtor can dissipate its cash reserves, and then the shareholder can rescue the company by providing it with "new value" in the form of a cash infusion. If the infusion is necessary and sufficient, some U.S. courts hold that it can bring the reorganization within the "new value exception" to the absolute priority rule. E.g., In re Landau Boat Co., 13 B.R. 788 (Bankr. W.D. Mo. 1981).

321. For further discussion of this point in the context of large U.S. reorganizations, see LoPucki & Whitford, Bargaining Over Equity's Share, supra note 18, at 154-56; In re Southland Corp., 124 B.R. 211 (Bankr. N.D. Tex. 1991).

322. See LoPucki & Whitford, Bargaining Over Equity's Share, supra note 18, at 137-41.

323. Bankruptcy Code § 1102(a)(1). In smaller cases, however, there may be an insufficient number of creditors willing to serve. See, e.g., LoPucki, The Debtor in Full Control, Part 2, supra note 18, at 250.

324. Bankruptcy Code § 1102(b)(1).
The U.S. Trustee, an agent of the U.S. Department of Justice, selects the members of the committees. With the court’s approval, these “official committees” may employ attorneys, accountants, and other agents to perform services for the committees. The court can, and usually does, require that the debtor’s estate pay the cost of these services. The ability of these committees to negotiate with or litigate against the debtor at the debtor’s expense gives them considerable leverage that counterbalances the agenda-setting advantage of the debtor described earlier. Although the rules discussed in this paragraph also govern small cases, committees are less necessary and less common in those contexts.

Neither the CCAA nor the BIA authorizes the formation or financing of committees. Yet, in this respect as well, the reorganization system is shaped largely by functional necessity. Committees appear to be formed and financed in cases under the CCAA with much the same frequency and in much the same kinds of cases as in the United States. The lack of authorizing legislation or administrative facilitation such as that provided by the U.S. trustee seems to make little difference, and there is no reason to believe that the practice will be different under the BIA. Once formed, the committees are usually successful in negotiating for the debtor to share the costs of their legal representation. Thus, the Canadian system establishes by contract roughly what the U.S. system has established through legislation. Continuing this parallel development of reorganization function through both law and private contract, a Canadian court recently ordered payment of committee expenses from the assets of a reorganizing debtor.

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325. Bankruptcy Code § 1102(a)(2).
326. Epstein et al., 3Bankruptcy, supra note 74, § 10-14.
327. See LoPucki, The Debtor in Full Control, Part 2, supra note 18, at 250 (creditors’ committees formed in only 40% of Chapter 11 cases and retained counsel in fewer than half of those cases).
328. The courts have inherent jurisdiction to order the formation of committees, but such an order is often unnecessary since the parties have their own incentives to form such committees.
329. Though it is not central to our thesis, it is interesting to speculate as to the sources of the leverage that enable the committees to extract payment of their fees and expenses. (Our speculation is based in part on explanations by Canadian reorganization lawyers.) To the extent that the loan agreements of those represented by the committees provide that legal costs following the debtor’s default, including restructuring negotiation costs, will be paid by the borrower, those represented may have a contract claim for the committee’s expenses. But many unsecured creditors have no contractual right to the payment of their attorneys’ fees in a reorganization case. The more compelling explanation is that the debtor pays part of the cost of the committees because the committees facilitate the debtor’s reorganization. That is, the debtor needs the votes of creditors to reorganize. The committees facilitate the winning of those votes by first, clarifying for the debtor during negotiations the interests and preferences of the creditors and second, credibly communicating to the creditors that the plan finally agreed to by the committee is in the interests of the creditors represented.
c. Limiting the Duration of Reorganization

There is much to be gained by preventing unnecessary delay in reorganization.\(^{331}\) The direct expenses of reorganization, principally in the form of professional fees, increase with the passage of time. Customers, suppliers, and employees, justifiably concerned with the company's ability to survive, may search for new business partners and eventually abandon the debtor. Creditors who are not receiving payments from the debtor during the reorganization case may encounter financial difficulty as a result. Court appearances may divert management's attention from the problems of the business. Perhaps most importantly, insolvency distorts the incentives of both the managers of the debtor company and those who control it. For these and other reasons, both the U.S. and Canadian systems seek to move reorganization cases to their appropriate conclusions as quickly as possible.\(^{332}\) There is, however, a substantial difference between the reorganization systems of the United States and Canada in the levels of their commitment to this goal. The Canadian system limits the duration of cases more aggressively than the U.S. system. The difference is manifest in legal doctrine in the form of shorter and more restrictive deadlines for the filing of plans and in harsher consequences for filing plans that are not accepted and approved. The difference is also revealed in the nature of the two systems' legal cultures and, perhaps most significantly, in the results produced. Canadians expect their reorganization cases to move faster and, although there has not been enough experience under the BIA to test this proposition empirically, it seems clear to us that ordinary BIA reorganizations will move considerably faster than ordinary reorganizations under Chapter 11.\(^{333}\)

As we discussed above, the BIA initially gives the debtor only thirty days from the filing of the notice of intention to file a proposal. The BIA authorizes the court to grant extensions, but only in increments of up to forty-five days, and for a total extension period not exceeding

\(^{331}\) The adverse effects of delay on reorganization are discussed in LoPucki, *The Trouble With Chapter 11*, supra note 18, at 732–39.

\(^{332}\) See, e.g., 28 U.S.C. § 586(c)(3)(G) (1988) (directing the U.S. trustee to monitor the progress of bankruptcy cases and take such actions as it deems appropriate to prevent undue delay).

\(^{333}\) The median time for U.S. reorganization cases is about 8 to 22 months. LoPucki, *The Trouble With Chapter 11*, supra note 18, at 732–39. A Canadian debtor who receives the maximum extensions permitted under the BIA is required to file its proposal within six months of the commencement of reorganization. Unless it wins adjournment of the meeting of creditors by vote of its creditors, the meeting will be concluded and the trustee's application to the court for final approval will be filed less than a month later. BIA §§ 51 (meeting of creditors to be held within 21 days of the filing of the proposal), 52 (adjournment of the meeting is by resolution of the creditors), 58 (trustee required to apply for court approval within five days of acceptance of the proposal by creditors).
five months.\textsuperscript{334} Extensions are to be granted only on a finding that the
debtor is acting in good faith and with due diligence, that the debtor
is capable of reorganization, and that no creditor would be materially
prejudiced by the extension.\textsuperscript{335} When a proposal is filed under the BIA,
the trustee calls a meeting of creditors, to be held within twenty-one
days, at which the creditors vote on the proposal.\textsuperscript{336} While adjourn­
ments are permitted, only the creditors are entitled to grant them.\textsuperscript{337}
If the proposal fails to obtain the requisite majority from unsecured
creditors, the debtor is deemed to have made an assignment in bank­
ruptcy and is liquidated.\textsuperscript{338} If the vote is in favor of the proposal, the
trustee must, within five days, apply to the court for a hearing on
approval.\textsuperscript{339} If the court refuses to approve the proposal, the debtor
again is deemed to have made an assignment and is liquidated.\textsuperscript{340}
Although one cannot rely entirely on legal doctrine as a basis for
predicting how long proceedings will take, we expect that ordinary
cases under the BIA will be resolved within two or three months after
the debtor files its proposal, for a total time in reorganization that will
be less than half the time taken by ordinary cases under Chapter 11.

Schedules similar to those in the BIA are frequently judicially
prescribed under CCAA orders. When a case is filed under the CCAA,
the court immediately fixes a deadline between one and six months in
the future for the filing of the debtor's plan. Although the courts can
grant extensions of their deadlines, most seem reluctant to do so when
the likelihood of a successful plan is slim.\textsuperscript{341} There is no statutory
guillotine such as that under the BIA; the failure of the creditors to
accept the debtor's initial proposal, however, is generally interpreted as
a strong indication that reorganization is not possible. By rejecting
the debtor's initial proposal, the creditors can likely force either the ap­
pointment of a receiver or the conversion of the case to bankruptcy
liquidation.

In contrast, U.S. law provides no specific deadline by which the
parties must either file a plan or complete the reorganization. Instead,
Chapter 11 gives the court discretion to control the length of the
proceedings in a variety of ways that we described in Part III.E. The

\textsuperscript{334} BIA § 50.4(9).
\textsuperscript{335} See, e.g., Re Malenfant (1993), 19 C.B.R. (3d) 295 (C.S. Que.) (extension denied because
debtor failed to establish good faith and due diligence, viability of proposal, and absence of
prejudice to creditors). See also supra part III.E.
\textsuperscript{336} BIA §§ 51, 54.
\textsuperscript{337} BIA § 52 (creditors can adjourn the meeting for further investigation).
\textsuperscript{338} BIA § 57(b).
\textsuperscript{339} BIA § 58(a).
\textsuperscript{340} BIA § 61(2).
\textsuperscript{341} For example, the Ontario Court declined to extend the short stay granted in the CCAA
court can fix a deadline for the debtor to file a plan and dismiss the case, or convert the case to Chapter 7 if the debtor does not meet the deadline,342 but few courts do so. Alternatively, the court can dismiss or convert the case if it is persuaded that the debtor is unable to effectuate a plan or that unreasonable delay by the debtor is prejudicial to creditors.343 The court can also permit creditors to seek confirmation of their own plan by refusing to extend the debtor’s period of exclusivity.344 Finally, on a secured creditor’s motion, the court can lift the automatic stay if the debtor has no equity in the collateral and the court concludes that a reorganization within a reasonable time is not likely.345 A separate statute authorizes the U.S. trustee to monitor Chapter 11 cases for the purpose of preventing undue delay.346

Although approximately three-quarters of all Chapter 11 cases do not result in confirmation of a plan,347 studies have shown that U.S. bankruptcy courts rarely terminate the reorganization effort of a debtor that is able to continue operating under the protection of Chapter 11.348 In contrast to the more active intervention of Canadian courts, United States courts wait for businesses to fail from their inability to pay current cash expenses. When that occurs, the shareholder-managers are likely to abandon the business, and only then is the court likely to dismiss or convert the case.349

V. CONCLUSION

We began this Article by presenting a methodology for comparing systems of reorganization through a “functional” or “systems” approach. This methodology regards reorganization as a functioning system that seeks to restructure the financial obligations of firms that are in financial distress yet still remain viable. The systems approach departs from traditional legal analysis by considering not just law, but all elements that contribute to a system’s ability to achieve its objectives. We then described our functional model of reorganization, based on the methods of systems analysis. We identified the apparent premises and goals of the reorganization systems in the United States and

343. Bankruptcy Code § 1112(b)(2), (3).
344. Particularly in large Chapter 11 cases, the “lifting” of exclusivity often results in a substantial loss of bargaining leverage for the debtor. Thus, the threat of loss of exclusivity can exert significant pressure on the debtor to speed up its reorganization.
345. See supra part III.E.
347. Empirical studies showing confirmation rates in Chapter 11 cases are collected in LoPucki & Whitford, Patterns, supra note 18, at 601 n.13. The rates vary dramatically with the size of the case and the business of the debtor.
348. See, e.g., LoPucki, The Debtor in Full Control, Part 2, supra note 18, at 258–63.
349. See id. at 263–66.
Canada, and analyzed the contribution of various components of the system to the accomplishment of those goals.

In Parts II through IV, we presented a detailed comparative analysis of how the Canadian and U.S. reorganization systems accomplish the basic functions necessary to support overall system operation. We attempted to present our analysis objectively and in terms that are, insofar as possible, empirically verifiable. Our comparison reveals striking contrasts in doctrine, but systematic parallels in function. We acknowledge that there are important differences in attitude between participants in the two systems. The Canadian system appears to place greater emphasis on preventing the use of court-supervised reorganizations by debtors that are unlikely to be able to reorganize successfully. In contrast, the U.S. system seems to place more emphasis on assuring that viable enterprises are not liquidated.350 As a result, the Canadian regimes are more severe in restricting access to the reorganization process. The U.S. system does little to restrict initial access, giving even those with relatively little chance of reorganizing the opportunity to try. Consistent with this basic philosophical difference, the Canadian system is also more aggressive in terminating reorganization cases after they begin. For example, Canadian courts insist on quicker progress toward reorganization351 and are more willing to permit large secured creditors to block the debtor's attempt at reorganization.352 As a result, a smaller proportion of financially distressed debtors has access to

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350. The reorganization systems in both countries strive to minimize the risk of (1) nonviable firms continuing to operate under the protection of the stay and (2) efficient enterprises being liquidated. In a recent paper, Michelle White calls the former “type I error” and the latter “type II error.” Michelle J. White, Corporate Bankruptcy as a Filtering Device (Mar. 29, 1992) (unpublished manuscript, on file with the Harvard International Law Journal). White’s observations support the proposition that the U.S. system places more emphasis on preservation of efficient enterprises:

Policy makers in the U.S. have tended to be more concerned with minimizing type II than type I error. In designing Chapter 11 of the U.S. Bankruptcy Code, Congress apparently viewed all or most failing firms as worthy of being saved, so that the cost in type I error of reducing type II error in bankruptcy was not considered.

Id. at 17. At the same time, however, the Canadian system runs a greater risk of Type II error (although the institution of private receiverships may reduce the severity of this error). See generally Theodore Eisenberg & Shoichi Tagashira, Should We Abolish Chapter 11? The Evidence from Japan, 22 J. LEGAL STUD. (forthcoming 1994); LoPucki & Whitford, Patterns, supra note 18 (considering levels of “success” in Chapter 11 by various measures).

351. On the basis of this difference, we speculate that Canadian reorganization cases succeed or fail much more quickly than their U.S. counterparts.

352. As discussed in this Article, the absence of a cram down rule in Canada means that a single secured creditor may be able to force the debtor to pay its claim in full simply by refusing to accept the plan. See supra part IV.B.2. Even if Canada has more liberal classification rules than the United States, there will be cases where secured creditors are sufficiently unique to be placed in a class of their own. If one such creditor moves to terminate the case and asserts that it will support no plan of the debtor, the court, if it believes that the debtor is viable, may give the debtor an opportunity to convince the creditor or buy out its claim. While some courts have shown such inclination, it is too early to discern a systematic pattern in this regard.
formal reorganization in Canada than in the United States. Moreover, once inside the system, the duration of their stay is likely to be much shorter.

Thus, while the structure of the two countries' systems is essentially the same, there are significant differences in attitude. The two systems for reorganization are like water faucets, and the cases are like the water flowing through them. While the structure of the faucet, the system, is the same in both instances, the attitudinal differences may control the speed and force of the water flow. These differences probably have a profound impact on outcomes. In the Canadian system, creditors have relatively more power than do debtors. Probably as a result, in the U.S. system, cases remain pending for longer periods of time.

We have demonstrated what we consider to be a remarkable similarity in function between the U.S. and Canadian systems for reorganization. This similarity in function is masked by sharp doctrinal differences. That is, the systems work in basically the same way, but the law describes their operation as being quite different. We repeat some of the more important instances here.

The concepts of an "estate" created at the moment of the filing of the reorganization case and a "debtor in possession" who manages the estate during the reorganization, are central to the U.S. lawyer's conception of Chapter 11. The estate is, for most purposes, regarded as an entity separate from the debtor. Nearly every legal explanation of what happens during reorganization, from the duties of management to the priority of those who finance the reorganization, employs these two concepts. Canada, on the other hand, employs neither of these concepts in its reorganization laws. The debtor company continues to hold its property, and its managers continue to make decisions under the supervision of the court. Yet, the Canadian reorganization system functions in these regards in almost the same way as that of the United States.

United States law employs an elaborately defined option to "assume or reject" executory contracts to explain, among other things, why the reorganizing debtor can for some time retain the benefits of some contracts without performing its obligations under them. Canadian law has no concept that corresponds to assumption or rejection of executory contracts, but it uses the concept of the automatic stay to reach essentially the same results.

353. See, e.g., LoPucki, The Debtor's Lawyer at Trojan Horse, supra note 183.
354. When we say that the Canadian regimes lack the "concept" of an estate, we mean that they neither use that word in their reorganization law nor recognize any legal entity that corresponds to an estate. The debtor is the same legal entity both before and after filing for reorganization.
Given that trustees are rarely appointed under Chapter 11, U.S. lawyers may be shocked to hear that a trustee serves in every case under the BIA. The shock should wear off quickly, however, as the U.S. lawyer comes to understand that the BIA trustee is selected by a method and employed in a capacity not unlike the attorney for the debtor in possession in the United States. They are both monitoring agents, selected by the debtor, who owe a duty to a group which extends beyond those who control the debtor and which includes the court and creditors.

A debtor whose plan fails to receive the required votes or court approval is treated harshly under Canadian law: under the BIA, a guillotine rule forces the debtor into liquidation, and a similar fate often follows under CCAA orders. In contrast, such a failure does not bring an end to the reorganization case under U.S. law. The court can permit the debtor to modify its plan. The functional significance of this doctrinal difference is diminished in light of several other provisions in the two systems.

United States law provides for the displacement of debtors in possession by a trustee where managers have been dishonest or incompetent. The Canadian reorganization system reaches a similar result by granting varying degrees of decision-making authority to the CCAA monitor or the BIA trustee, as interim receiver, or by converting reorganizations to liquidations so that a bankruptcy trustee will be appointed. This bankruptcy trustee has the authority to file a proposal for reorganization. Therefore, the difference between the two systems with respect to second attempts is no more than the following: after the initial failure of a plan, renewed reorganization attempts must be conducted by the Canadian bankruptcy trustee, as opposed to the U.S. debtor in possession. Moreover, the difference disappears in U.S. cases where the managers have been dishonest or incompetent, because in these instances an officer of the court takes charge of the reorganization.

A central feature of any doctrinal view of Chapter 11 is the court's ability to cram down on creditors and shareholders a plan that is fair and equitable to them and does not discriminate unfairly against them. Canadian lawmakers have expressly rejected the doctrinal concept of cram down. Yet, in operation, the Canadian system may reach a rough functional equivalence through a variety of devices. With regard to secured claims, this rough equivalence is achieved through broader classification rules. With regard to claims and interests that are partly or completely under water, the Canadian system is capable of achieving the functional equivalence of cram down through means such as issuing a simple order under the corporation law that dismisses the vote of under water shareholders as unnecessary. Another device is requiring creditors whose claims are partly under water to accept a distribution
in exchange for their claims through sale of the business as a going concern.

What accounts for this tendency to reach a functional equivalence through different means? If the similarities in function between these two systems were the result of the migration of laws, either to Canada from the United States or to both Canada and the United States from England, we would not expect these sharp doctrinal differences to accompany them. Many countries examine foreign laws in the course of developing their own, and it is common for countries to adopt aspects of foreign laws. Although Canada has been aware of the U.S. experience with Chapter 11, its lawmakers have certainly not copied it. Instead, they set out to create a “made-in-Canada” solution to the common problems. Our thesis is that because both countries have market economies and share the same assumptions and broad objectives for formal reorganization, it was highly likely, if not inevitable, that the two countries would develop reorganization systems that function in essentially the same way. The functional aspects of these systems were shaped not by culture or politics, but by necessity.

An implication of our Article, therefore, is that the functional aspects of judicially supervised reorganization systems tend to converge. If we are correct, any country that opts for court-supervised reorganization against a similar economic background is likely to arrive at the same functional solutions. Our approach may be used to confirm this thesis more broadly across a larger sample of countries. Where there are significant functional differences, researchers will likely find that one system has evolved further and works better than the other in those respects. Thus, the methodology we present here is also a means for sharpening the focus of normative evaluations of reorganization systems. For example, we noted above that the United States and Canada have struck different balances between their common policies of assuring protection to viable businesses and preventing use of the system by nonviable ones. Presumably, there is an optimal balance to be reached between the two conflicting objectives. Given the difference between the two systems in this respect and the similarity between them in virtually all others, it should be possible to determine the relative merits of the two approaches through an empirical comparison of the outcomes of reorganization in the two countries.

Systems analysis offers both a theory for understanding and comparing systems in which law is a component and a language for legal discourse. One measure of a theory, expressed in Occam’s razor, is

355. See generally SCHLESINGER ET AL., supra note 5, at 8–12.
356. While there are a number of statements of Occam’s famous principle, we think that Jaszi has given it the best expression: “The more complicated an explanation for a phenomenon, the
whether it offers a simpler explanation of observed phenomena than do existing theories. The goal of legal doctrine is to offer simple and useful explanations for the rules governing human interaction. For example, the legal fiction of the corporation as a person purports to explain a variety of relationships between fact situations and legal outcomes. Yet, in financial economics, for example, the theory of the corporation as entity already has yielded to a competing theory of the corporation as a set of contracts among those involved in corporate affairs, again with the similar objective of presenting an analytically helpful heuristic device. The goal of legal doctrine is to offer simple and useful explanations for the rules governing human interaction. For example, the legal fiction of the corporation as a person purports to explain a variety of relationships between fact situations and legal outcomes. Yet, in financial economics, for example, the theory of the corporation as entity already has yielded to a competing theory of the corporation as a set of contracts among those involved in corporate affairs, again with the similar objective of presenting an analytically helpful heuristic device. The goal of legal doctrine is to offer simple and useful explanations for the rules governing human interaction. For example, the legal fiction of the corporation as a person purports to explain a variety of relationships between fact situations and legal outcomes. Yet, in financial economics, for example, the theory of the corporation as entity already has yielded to a competing theory of the corporation as a set of contracts among those involved in corporate affairs, again with the similar objective of presenting an analytically helpful heuristic device. Our analysis demonstrates that the systems approach yields a simpler and thus even more powerful comparison of the reorganization systems of Canada and the United States than the doctrine employed by the courts in their legal reasoning. If we are correct, basic concepts of law such as the estate or rejection of an executory contract may become outmoded, and the disintegration of doctrinal discourse may be at hand.

less it is to be preferred, especially where another, simpler explanation, with a better fit to the available data, is ready at hand.” Peter A. Jaszi, Brief of Appellant Edward De Vere, Seventeenth Earl of Oxford, 37 AM. U.L. REV. 645, 653 (1988).


358. Scholars have been struggling for decades with the problem of reconciling the differences among reorganization systems when they affect the cases of debtors with assets in more than one country. See, e.g., Donald T. Trautman et al., Four Models for International Bankruptcy, 41 AM. J. COMP. L. 575 (1993). The problem may be more manageable if a functional rather than a doctrinal analysis of the reorganization systems involved is used to identify the differences between them.