REORGANIZATIONS UNDER THE COMPANIES' CREDITORS ARRANGEMENT ACT

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Introduction

The Companies' Creditors Arrangement Act[1] (which I will refer to as the C.C.A.A.) poses many interesting problems and has great potential importance. In spite of this, it has received little attention in either Canadian legal literature or the decisions of the courts. This Act was passed during the depression to provide a means by which an insolvent company could avoid or get out of bankruptcy by composing or rearranging the rights of its shareholders and creditors, and thereby maintain its going concern value. This process is called "reorganization". For the sake of simplicity I will consider the C.C.A.A. only as applied conjointly with section 123 of the Dominion Companies' Act, although section 19 provides that it may likewise be invoked in conjunction with similar provisions in any of the provincial incorporation statutes.

Summary

In this article I will discuss the main problems which counsel and the courts will face in applying the Act, and suggest an approach for their solution. It may be useful to provide here a summary of the points to be dealt with, for the convenience of those who desire it.

1. A brief general description of a reorganization as carried out under the C.C.A.A. and the responsibility of counsel and the court.
2. The importance of the C.C.A.A.
3. The value of examining the reorganization law developed in the United States.
4. A statement of the usual purpose of reorganization.
5. The public interest as a factor to be considered.
6. The problem of making the plan feasible.
7. The problems of fairness and equitableness.
8. A consideration of the position of the corporate management.

[1] 23–24 George V, 1932–33, c. 36.

9. The necessity for the court to make an "informed independent judgment".

10. The classification of creditors and shareholders and direction of meetings by the court.

11. Conditions precedent to the sanction of a plan by the court, including:

(a) The content of circulars mailed to the parties.

(b) Proxy forms.

(c) The majority required in the vote.

(d) The necessity that the vote be in good faith.

12. The role of the court in considering the merits of a reorganization plan.

13. Conclusions.

Outline of Reorganization under the C.C.A.A.

Under a typical reorganization plan the bonds and shares of the company are cancelled and new ones of different kinds and in different amounts are issued to their holders. The claims of other creditors are also reduced or exchanged for bonds or shares. Care is usually taken that the new debt is not more than the business will easily carry and that the new share capital is not disproportionate to the value of the enterprise. To this end each class is ordinarily given securities less substantial than those which it previously held, and the greatest sacrifices are usually made by the classes most junior in interest.

The C.C.A.A. and section 123 of the Dominion Companies' Act make available a procedure for the formation and enforcement of a reorganization plan. They provide that when a compromise or arrangement is proposed between a company and any of its creditors or shareholders, the court upon application may order meetings of the classes of creditors and shareholders affected. If the majority in number representing three-fourths in value of each class of creditors voting, and shareholders representing three-fourths of the shares represented and voted of each class, agree to the compromise or arrangement or a modification of it, the court may sanction it. The voting may be either in person or by proxy. If these requirements are met and the court order is deposited with the Secretary of State, the arrangement becomes binding upon the company and all of the parties affected by it.

The work of formulating and proposing the plan thus ordinarily falls upon either the management, the liquidator or trustee of the company, or a group of its creditors. The proponents of the arrangement must undertake the expense, the work and the responsibility of preparing a complete reorganization plan. They will be unwise to prepare any scheme which is unlikely to be accepted by an overwhelming majority of each class of creditors and shareholders and by the court. The proponents also have the duty ordinarily of sending out all circulars and notices to the parties affected, of conducting the meetings, and if a plan is agreed to, of presenting it to the court for final sanction. These considerations impose upon counsel a heavy responsibility to devise a plan which is not only workable and likely to be approved, but also as equitable as possible to all the parties affected.

The court has an opportunity to see and deal with the plan at only two points. The first of these occurs when the application is made to direct the meetings, at which time its powers are very limited. The other is when the scheme is brought to it for final sanction. By this time a great deal of time and money have already been spent upon the plan by its proponents. Its power even at this stage is limited to a choice between sanctioning and vetoing the completed arrangement, and the statute provides little guidance to assist it in making this choice. The court at this point faces the difficult problem of deciding how serious an impropriety in the procedure or the plan must be to require the refusal of its approval. Such a refusal may have the effect of discarding the agreement already achieved after long and expenisve preparation.

It would appear that a statutory scheme might be worked out which would permit the accomplishment of reorganizations with less hazards of failure and less hardship on specific groups and individuals. As the continuity of operation of corporations during times of difficulty becomes more important in our economy, there is a growing need for the working out, either through new legislation or through decisions of the courts, or both, a body of law which will make reorganizations more workable and equitable. Because of the possibility that no such legislation will be immediately forthcoming, and in order to provide some basis for amending the C.C.A.A. if and when it does come, it would appear desirable for counsel in preparing plans and for courts in rendering judgments under the act as it now stands, to aim toward that objective.

Importance of the C.C.A.A.

There are a number of conditions and tendencies in this country which underline the importance of this statute. There has been over the last few years a rapid and continuous growth of industry, primarily manufacturing. The tendency here, as in other expanding private enterprise countries, is for the average size of corporations to increase faster than the number of them, and for much of the new wealth to be concentrated in the hands of existing companies or their successors.[2] The results of permitting dissolutions of companies without giving the parties an adequate opportunity to reorganize them would therefore likely be more serious in the future than they have been in the past.

Because of the country's relatively small population, however, Canadian industry is and will probably continue to be very much dependent on world markets and consequently vulnerable to world depressions. If there should be such a depression it will become particularly important that an adequate reorganization procedure should be in existence, so that the Canadian economy will not be permanently injured by discontinuance of its industries, so that whatever going concern value the insolvent companies have will not be lost through dismemberment and sale of their assets, so that their employees will not be thrown out of work, and so that large numbers of investors will not be deprived of their claims and their opportunity to share in the fruits of the future activities of the corporations. While we hope that this dismal prospect will not materialize, it is nevertheless a possibility which must be recognized. But whether it does or not, the growing importance of large companies in Canada will make it important that adequate provision be made for reorganization of insolvent corporations.

American Reorganization Law

Much may be gained in this study by a consideration of the reorganization law of other countries. The C.C.A.A. has as yet

[2] See Berle & Means: The Modern Corporation and Private Property (1933), at p. 18 *ff.* The Canada Year Book (1946) 1134; (1938) 1061, reveals that from 1900 to 1945 inclusive, 24,377 new companies were incorporated under Dominion Law with a total capitalization of about 12½ billion dollars, the total net increase in capitalizations over the same period being approximately 14⅔ billion. It is to be noted that in the year 1945 the total capitalization of new companies was 57.6 million dollars, while the total increase in capitalizations of existing companies was 108.4 million. These figures and those for the years leading up to 1945 would indicate that new wealth is being increasingly concentrated in existing companies and that the average company is probably getting larger.

seldom been invoked. When the courts have considered arrangements they have frequently failed to give written reasons for their decisions.[3] The judges have tended to approve automatically any scheme which has received the required votes of creditors and shareholders, unless some error in procedure has been called to their attention.[4] This situation is in striking contrast with that existing in the United States where there is a much more detailed statutory procedure and where there have been repeated and numerous pronouncements upon many aspects of reorganization by the Supreme Court as well as by many of the lower courts. This has provided a somewhat uniform and stable body of law to guide lawyers in devising sound plans for their clients, and judges in deciding whether or not to approve proposals. Reorganizations have become sufficiently prevalent that a recent American writer has said that "most modern corporations never die; they continue to live in reorganized form".[5]

There are several factors which have contributed to this situation. The American courts have been influenced to consider the problems fully by the constitutional prohibition against taking away property (from creditors) without due process of law. They were also made aware of many of the problems by the comprehensive report which was published after an extensive investigation by the Securities and Exchange Commission.[6] This report, a reading of which incidentally is most important to an understanding of the problems of the fairness of reorganizations, directed attention to many of the practices of corporate managements, and was the impelling force behind the passing in 1938 of the present American reorganization statute, Chapter X of the Chandler Act.[7]

The main underlying reason for the difference, however, is that corporations have not been and are still not so numerous or so large in Canada as in the United States. The problems arising

[3] The Annual Report of the Secretary of State reveals that since the C.C.A.A. was passed, there has been an average of approximately ten confirmations of compromises or arrangements per year. This includes those accomplished under the Bankruptcy Act, the Winding Up Act and Section 122 of the Companies Act as well as the C.C.A.A. I can find no more than seven reported decisions which deal with or even refer to proposals under the C.C.A.A. and there is no discussion of the merits of the plan in any of them.

[4] *Cf.* Gold: Preference Shareholders in the Reconstruction of English Companies, (1943-44), 5 University of Toronto Law Journal 282, at p. 284.

[5] Kehl: Corporate Dividends, at p. 20.

[6] S. E. C. Report on Protective and Reorganization Committees (1940), particularly the conclusions and recommendations on pages 308 to 343 incl. in Part VIII.

[7] 52 Stat. 883 (1938); 11 U. S. C. s. 501 *ff.*, (1946).

have accordingly been less numerous and less complex. There was little reorganization law in America when its economic development was at a stage comparable to Canada's present condition. Canadians are fortunately in a position to adopt the portions they choose from the solutions, both statutory and judicial, which have been worked out in the United States and Great Britain. The wisdom of the procedures and rules worked out there will be examined in the light of Canadian conditions in an effort to devise the fairest and most feasible scheme possible for application of the C.C.A.A.

Purpose and Principles of Reorganization

It is important in applying the C.C.A.A. to keep in mind its purpose and several fundamental principles which may serve to accomplish that purpose. Its object, as one Ontario judge has stated in a number of cases,[8] is to keep a company going despite insolvency. Hon. C. H. Cahan when he introduced the bill into the House of Commons indicated that it was designed to permit a corporation, through reorganization, to continue its business, and thereby to prevent its organization being disrupted and its goodwill lost.[9] It may be that the main value of the assets of a company is derived from their being fitted together into one system and that individually they are worth little. The trade connections associated with the system and held by the management may also be valuable. In the case of a large company it is probable that no buyer can be found who would be able and willing to buy the enterprise as a whole and pay its going concern value. The alternative to reorganization then is often a sale of the property piecemeal for an amount which would yield little satisfaction to the creditors and none at all to the shareholders.

Reorganization may give to those who have a financial stake in the company an opportunity to salvage its intangible assets. To accomplish this they must ordinarily give up some of their nominal rights, in order to keep the enterprise going until business is better or defects in the management can be remedied. This object may be furthered by providing in the reorganization plan for such matters as a shift in control of the company or reduction of the fixed charges to such a degree as to make it possible to raise new money through new issues of

[8] *In re D. W. McIntosh Ltd.*, (1939), 20 C.B.R. 234, at p. 251 (Ont.); *In re Avery Construction Co. Ltd.*, (1943), 24 C.B.R. 17 (Ont.); *In re Arthur Flint Co. Ltd.* (1944), 25 C.B.R. 156 (Ont.) (Urquhart J.).

[9] House of Commons Debates, Canada, 1932-33, Vol. IV, 4090-91.

bonds or shares. It may therefore be in the interest of all parties concerned to give up their claims against an insolvent company in exchange for new securities of lower nominal amount and later maturity date.

Public Interest

Another reason which is usually operative in favour of reorganization is the interest of the public in the continuation of the enterprise, particularly if the company supplies commodities or services that are necessary or desirable to large numbers of consumers, or if it employs large numbers of workers who would be thrown out of employment by its liquidation. This public interest may be reflected in the decisions of the creditors and shareholders of the company and is undoubtedly a factor which a court would wish to consider in deciding whether to sanction an arrangement under the C. C. A. A.

The need for consummating a satisfactory reorganization of the Abitibi Power and Paper Company was seen by the Ontario government which, after several abortive attempts to bring the parties together and the passage of a special statute[10] to prevent dismemberment of its assets in the meantime, finally appointed a special committee for the purpose of negotiating a reorganization agreement. These steps led to the final approval and sanction of a plan early in 1946, the return of the company to private management, and its subsequent profitable operation.

In the United States the interest of the public is protected by requiring that administrative tribunals play a leading part in reorganizations. The Securities and Exchange Commission is entitled to receive notice of all steps taken, to formulate plans of its own, to investigate those proposed by others, and to report on the various proposals to the creditors, the stockholders and the court. Labour unions may be heard on the question of the economic soundness of any plan affecting the interests of employees. These are among the provisions which are made in Chapter X of the Chandler Act for protecting the public interest in its various aspects. It thus becomes apparent that consumer, investor and labor groups as well as the public generally are interested in reorganizations, and accordingly their welfare

[10] The Abitibi Power & Paper Company Limited Moratorium Act, 5 Geo. VI, 1941 (Ont.), c. 1. The constitutionality of this statute was seriously contested, but it was finally held by the Privy Council to be valid. *Abi ibi Power & Paper Co. Ltd.* v. *Montreal Trust Co. et al.*, L.R. [1943] A.C. 536 (P.C.).

should be kept in mind by those who are supervising that procedure.

Feasibility

The first principle of reorganization is that the plan should be so framed that it is likely to accomplish its purposes. One respect in which it may be defective is that a new debt structure may be created which contains the seeds of another insolvency. The difficulties of an insolvent company are often the result of its having fixed principal and interest charges which are too high for the business to carry successfully. The plan should therefore ordinarily provide for lessening these charges by reducing the amounts of the debts, by issuing income bonds or preferred shares in exchange for debentures, or by a combination of these and other methods. In order to be as certain as possible that the company will be able to pay all of its fixed charges and have a surplus available for payment of dividends in the future, it might be advisable, where cost is not prohibitive, to have a competent appraiser estimate the future earnings of the enterprise on a conservative basis. This might then be used as a guide in limiting the new debt structure. In the United States it has been held that a plan will not be approved which is deficient in this regard.[11]

This requirement may make it necessary to give new shares to former creditors and in turn relegate the former shareholders to positions junior in the capital structure to those they previously held. In carrying out this reshuffling process it may appear that if new shares are created, equal in par value to all of the former debts and shares, some of them will have practically no chance of ever participating in the distribution of the earnings of the company. It may therefore appear desirable to provide the company with a capital structure in which the cumulative dividends are not excessive in amount and the aggregate par value of the shares is not disproportionately high. For this purpose, however, it would be proper to use as a guide a more liberal estimate of future earnings,[12] since a capitalization which proves to be over optimistic does not carry the risk of further insolvency which attends an oversized debt structure.

A further element of feasibility is that the plan should embrace all parties if possible, but particularly secured creditors,

[11] *Cf. In re Flour Mills of America, Inc.*, 7 S.E.C. 1, at pp. 26–7 (1940); *Taylor et al.* v. *Standard Gas & Electric Co.*, 306 U.S. 307 (1939).

[12] *Cf. Consolidated Rock Products Co. et al.* v. *Dubois*, 312 U.S. 510, at pp. 525–7 (1941).

so that they will not be left in a position to foreclose and dismember the assets after the arrangement is sanctioned as they did in one case.[13]

Fairness

In addition to being feasible, a reorganization plan should be fair and equitable as between the parties. In order to make the Act workable it has been necessary to permit a majority of each class, with court approval, to bind the minority to the terms of an arrangement. This provision is justified as a precaution that minorities should not be permitted to block or unduly delay the reorganization for reasons that are not common to other members of the same class of creditors or shareholders, or are contrary to the public interest. If small groups are placed in too strong a position they become capable of acquiring a nuisance value which will make it necessary for the reorganizers to buy them off at a high price in order to effectuate the plan successfully.[14] However, care should be taken that this statutory power of binding minorities should not be utilized to confiscate the legitimate claims of those minorities or of any class of creditors or shareholders.

In order to make an equitable redistribution of the securities of a company and the other claims against it, it is important to classify the creditors and shareholders according to their contract rights. Most important will be their respective rights of participation in the distribution of the company's income while it is operating, and its assets on liquidation. Included also will be the power which secured creditors would have but for the C. C. A. A. to realize upon the property by foreclosure in priority to other claimants. I would suggest that the aspect of these rights to be first considered should be not their face or nominal value, but rather what they would in reality be worth if the company had been liquidated rather than reorganized. This would entail a valuation and estimate of what the assets would bring at a public sale, or be worth to the secured creditors upon foreclosure. There can hardly be a dispute as to the right of each of the parties to receive under the proposal at least as much as he would have received if there had been no reorganization. Since the company is insolvent, this is the amount he would have received upon liquidation.

[13] *In re Arthur Flint Co. Ltd.*, (1944), 25 C.B.R. 156 (Ont.).
[14] Foster: Conflicting Ideals for Reorganization, 44 Yale Law Journal 923, at pp. 928–9 (1935).

Since, however, the company is being reorganized in order to make it worth more than it would be upon liquidation, the question next arising is how the resulting increase in value is to be distributed. In other words what parties are to participate in the excess of reorganized or going concern value over liquidation value and in what proportion. The United States Supreme Court by adopting the absolute priority doctrine as a "fixed principle", has in effect compelled the full recognition in a plan of all of the former nominal participation rights of senior claimants in priority to any rights of junior creditors or stockholders.[15] It has held that although the requirements of feasibility may preclude giving senior claimants the same type of participation as they had before, they may be compensated for giving up seniority or a high interest rate by giving them a larger face value of inferior securities or some other concession. This rule, together with the requirement of keeping the capitalization within the limits dictated by anticipated earning power, may well necessitate the exclusion of some of the junior classes from any participation in the reorganized company,[16] although they should not be excluded if there is any reasonable likelihood that after full consideration of prior rights there will be any equity left for them. The United States Supreme Court has held that the only way in which junior classes without any equity may otherwise participate is by contributing new capital approximately equal in value to the rights which are accorded them.[17]

In England, on the other hand, the courts will sanction any scheme if the formal statutory requirements have been satisfied and if the senior classes obtain at least what they would be entitled to on liquidation, regardless of how the increase in value resulting from the reorganization is distributed. The principle which they have adopted is that any scheme is fair as between the classes if it is one which any member of each class acting reasonably in the interest of that class would approve as a businessman.[18] Our problem is whether to adopt one of these rules or whether a third formula can be worked out which is more desirable than either one.

[15] *Northern Pacific Ry. Co.* v. *Boyd*, 228 U.S. 482 (1913); *Case* v. *Los Angelos Lumber Products Co.*, 308 U.S. 106 (1939).

[16] *Cf. In the Matter of Flour Mills of America*, 7 S.E.C. 1, at p. 30 (1940); *Group of Institutional Investors et al.* v. *Chicago, M. St. Paul & P. R. Co.*, 318 U.S. 523 (1943); *Ecker* v. *Western Pac. R. R. Corp.*, 318 U.S. 448 (1943).

[17] *Case* v. *Los Angelos Lumber Products Co.*, 308 U.S. 106 (1939).

[18] *In re Alabama, N. O., T. & P. J. Ry. Co.*, L.R. [1891] 1 Ch. 213 (Court of Appeal).

Subject to what will hereafter be said about the position of management and relaxation of rules in the interest of making the C. C. A. A. workable, it would seem to me that considerations of policy point to the desirability of adopting the American rule. When people invest in corporate bonds or otherwise advance money, goods or services to a company, they do so on the understanding that they are to have priority over junior creditors and shareholders for the full amount of their claims, both as to principal and interest. The sanctity of contract rights generally and the security of investors in particular are factors which would undoubtedly make it undesirable to deprive them of their seniority unless there is a compelling reason for so doing. In deciding how the excess of reorganized value over liquidation value may fairly be distributed, therefore, I would suggest that paramount consideration should be given so far as possible to the recognition of the nominal legal rights of the respective classes to participate in the profits and property of the old company.

The Position of Management

One important question is whether, in considering the fairness of a proposal, special consideration should be given to a class of shares in which the management of the company has a substantial interest. Although there is an increasing tendency in large corporations for control to be assumed by a small group which owns relatively few shares,[19] management still owns a substantial proportion of at least one class of stock in many companies. Where that is the case it may be desirable to provide it with an incentive to promote the reorganization and to remain with the company thereafter by giving special consideration to the class or classes of shares which it holds in large amounts.

What are the powers for good or evil of the management which will affect our decision in this matter? The prospect of the continuation of the services of the managers of the company may be one of the factors which contributes to its going concern value. The value of their business connections, their experience and their knowledge of the business may even be the main factors in inducing creditors and shareholders to believe that the reorganization is worthwhile. Furthermore, because of the strategic position of management and the concentration of power therein it is frequently only through its efforts that a reorganization can

[19] Berle & Means: The Modern Corporation and Private Property (1933), at p. 69 *ff.*

be brought about. On the other hand the creditors and shareholders not connected with management would not be able to contact each other easily, and would not have either enough knowledge and experience or sufficient individual interest in the enterprise to make it worthwhile for them to formulate a plan and arrange for its effectuation.

In addition to being able to make these positive contributions, management, under existing law, has the negative power to make reorganization difficult. It can do this by failing to take steps to protect the interests of the security holders or delaying the proceedings in one way or another.[20] For these reasons, management is able to exert a profound influence for either the success or failure of the reorganization.

The United States Supreme Court has held that the value of management to the company would not justify the participation of all holders of the common stock in a reorganization plan, because some members of that class did not have anything to do with managing the company, and because those that did were under no legal obligation to continue their services. The court said that they should not be allowed to profit because of their "nuisance value".[21] It may well be contended, however, that benefits flowing from the strategic position of the management, if not used for unlawful or improper purposes, are as much property rights as the right to participate in the distribution of the company's income and assets. Whether this is so or not, it is a practical reality that where management owns a substantial number of shares it usually cannot be persuaded to further the reorganization if it is not to be permitted to participate. Furthermore, the managers are far more likely to continue with the company after reorganization and strive to improve its position if they are in a position to profit from increases in the profits and in the value of the assets.

I would therefore suggest that where management owns a substantial proportion of any class of shares and where its services are desired for the reorganization or thereafter, that class should be given special consideration in the reorganization plan. The extent of any participation accorded them for this reason, however, should be determined solely by the interest in such participation which, because of the factors mentioned above, is had by the classes with equity in the assets.

[20] *Cf.* Foster: Conflicting Ideals for Reorganization, 44 Yale L.J. 923 (1935); Gold: Preference Shareholders in the Reconstruction of English Companies, (1943-44), 5 U. of Tor. L. J. 282.

[21] *Case* v. *Los Angelos Lumber Products Co.*, 308 U.S. 106 (1939).

Introduction to a consideration of problems under the C.C.A.A.

We have seen that the purpose of the C.C.A.A., the interests of the public and investors but particularly the creditors, the position of management, and the requirements of feasibility and fairness are all matters which should be considered in order to apply the Act properly. Accordingly Canadian lawyers and judges should endeavour to work out a formula which will recognize the proper significance of each of them and at the same time make the Act workable.

When deciding questions under the C.C.A.A. care should be taken not to apply too dogmatically the decisions which have been rendered in cases dealing with arrangements between classes of shareholders in which creditors are not involved. Although the statutory provisions for the latter in the various Companies Acts look similar in important particulars to the C.C.A.A., and although both types of arrangements are governed by the same section (153) of the British Companies Act, they may clearly be distinguished. The significant difference is that in cases under the C.C.A.A. the company is insolvent and the creditors who are the most important group in the proceedings would be, but for this Act, in a position to enforce their claims and liquidate the enterprise. On the other hand in the Companies Act arrangements, the senior class affected is usually the preferred shareholders who have no right to bring about liquidation or enforce their preferences in any way except to prevent distributions to the common shareholders while their claims are unsatisfied. If these shares are in reality worth their face value it is purely by chance.[22] There is therefore much less reason to insist on the maintenance of priorities in an arrangement among shareholders of a solvent company, than there is for denying participation to junior classes in the reorganization of an insolvent company before the senior claimants have received at least what they would have got on liquidation, and probably their full liquidation preference. Sup-

[22] *Cf.* Dodd: Fair and Equitable Recapitalizations, 55 Harvard Law Review 780, at p. 795. In this article "reorganizations", arrangements for insolvent companies in which the rights of creditors are modified, are clearly distinguished from "recapitalizations", arrangements for solvent companies involving modification of the relative rights of classes of shareholders. These are the terms used in the United States to distinguish the two situations. It is here argued that even if the liquidation preference of the preferred shares is greater than the value of the enterprise, these shares are still not worth that value. The common shares are still valuable property rights — tickets evidencing a bet that the corporation's future will be better than its past. "The situation differs radically from reorganization, where the creditors have contract rights which would, in most cases, entitle them to liquidate the enterprise and take over its entire assets if it were not for the reorganization provisions of the Bankruptcy Act".

porting this conclusion is the fact that the C.C.A.A. was held constitutional as being legislation relating to bankruptcy and insolvency, the primary purpose of which has traditionally been to protect the rights of creditors.

Necessity for an "informed, independent judgment"

It has been stated by Mr. Justice Brandeis in delivering the opinion of the United States Supreme Court reversing the lower court's approval of a reorganization plan, that "every important determination by the court . . . calls for *an informed, independent judgment*".[23] One of the reasons given for this holding was that "the proceeding was not an adversary one". His opinion implies that this type of decision differs from ordinary litigation between private parties in that here the judge must consider all points which could possibly affect his decision whether or not they are raised in court by opponents of the scheme. Many of the claims may be so small and held by creditors so widely scattered that it would be impractical for them to be represented at the hearing. In addition, the effects of a reorganization, not only upon the parties directly affected, but upon the public generally, are so widespread that it would be inauspicious for the review to be confined to questions raised by creditors and shareholders at the hearing.

The English judges, although they have not stated this principle, appear to have made their decisions in accordance with it in reorganization cases. They have remarked on occasion that the dice are loaded in favor of the views of the directors[24] and that the force of the creditors is nothing as against that of the forces trying to secure adoption of the scheme. Their criterion is that the court "*must be satisfied*" that the necessary steps have been taken and that the proposal is sufficiently fair and reasonable.[25] Canadian courts have held that the onus is on the proponents of a plan to establish that the conditions precedent have been complied with, [26] and have followed the English rule as to the necessity of the court being satisfied regarding the merits of the scheme.[27]

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[23] *National Security Co.* v. *Coriell*, 289 U.S. 426, at p. 436 (1933).

[24] *In re Dorman, Long & Co., Ltd.*, L.R. [1934] Ch. 635, at pp. 657–8.

[25] *In re English, Scottish and Australian Chartered Bank*, L.R. [1893] 3 Ch. 385 (C. of A.), per Lindley L.J., at 408.

[26] *Re Langleys Ltd.*, [1938] O.R. 123, at p. 132.

[27] *In re Provincial Apts. Ltd.*, [1936] 3 W.W.R. 327 (Sask.); *Re Dairy Corp. of Canada Ltd.*, [1934] O.R. 436; *In re Gareau* (1922), 2 C.B.R. 265 (Que.).

In addition to making an "independent" judgment the court ought to be "informed" as to all matters relevant to the making of a proper decision. What facts it should know may be inferred from a consideration of each of the conditions precedent, hereinafter mentioned, which must be established, and the requirements of fairness and feasibility. These would include adequate data as to what factors of public interest are involved, the past and present financial condition of the company, detailed accounts of its liabilities indicating their respective priorities as to security and otherwise, conflicts of interest in the case of any of the creditors and shareholders, valuation of what the assets would likely bring at a public sale, and estimates of probable future earnings of the reorganized company.[28] It would also be desirable that the proposed plan be carefully analysed in the light of all this information, preferably by a competent expert, and that the result of the analysis indicate that all of the tests of compliance with the words and purpose of the statute were satisfied.

Powers and duties of the judge who directs the meetings

A judge has power under sections 3 and 4 of the C.C.A.A. and section 123 of the Dominion Companies Act to order meetings of the classes of creditors and shareholders affected, "to be summoned in such manner as the court directs". This discretion should be exercised very carefully, keeping in mind the purposes of the Act and all the principles of reorganization, since a careless or improper direction may prejudice the success of the entire proceeding by denying the conditions which make for an informed and impartial vote by the creditors and shareholders in their proper classes.

There are two or three preliminary questions which must be answered in the affirmative before the court can accept jurisdiction. It will be necessary to decide first of all that it is a "company" within the definition provided in section 2(b), and secondly that it is bankrupt or insolvent and hence a "debtor company" as defined in section 2(c). It must then be established that the parties with whom the arrangement is proposed are "creditors" within the appropriate definition.[29] Another problem which may arise is whether the plan proposed is a "compromise or arrange-

[28] *In re Bunn-Munro Ltd.*, [1923] 3 W.W.R. 314 (Sask.). In this case Taylor J. in a very interesting judgment refused to sanction a reduction of capital scheme, because insufficient information was produced by the applicant. He enumerated many of the items mentioned in the text and said that data were required with respect to them.

[29] 23–24 George V, 1932–33, c. 36, s. 2 (f) (secured creditors) and s. 2 (g) (unsecured creditors).

ment". There can be little doubt, however, that the term "arrangement" as generally understood, and also as defined in section 122(4) of the Companies Act and extended by the context of the C.C.A.A. should be construed very broadly and will include any reorganization as that process is contemplated in this article.

Another preliminary question concerns the exercise by the court of its discretion as to procedure. It would ordinarily find it desirable that notice of the application for the summoning of meetings be given to all the parties or their representatives, and that they be heard on the motion, rather than that its direction should be made ex parte. A hearing of all the parties on the original application will aid the court in avoiding errors and will assist it in obtaining as full a knowledge as possible of the company's affairs, — a knowledge which will be very valuable to it in exercising its discretion.

Classification of the Creditors

Classification of the creditors is the next problem which the court will face. Creditors should be classified according to their contract rights, — that is according to their respective interests in the company. Sections 3 and 4 of the C.C.A.A. provide for a compromise or arrangement with the creditors "or any class of them", and for the direction of a meeting of "such creditors or class of creditors". Hon. C. H. Cahan's remarks made in the House of Commons while he was sponsoring the passage of the bill,[30] make clear how each class of creditors is to be constituted. In discussing section 4 he said: "*Each class of creditors who have the same interest* may decide by a three-fourths majority with respect to any proposed compromise and, if approved by the court, such compromise becomes effective". In suggesting a change of wording in section 5 he made the following statement: "The suggestion is that it should be made clear that *each class of creditors having the same interest* shall decide among themselves as to the terms of the compromise, and I think this proposed amendment makes the matter very much clearer". This history indicates that the intention of the statute was to require classification of the creditors according to their interest in the company.

Chapter X of the American Chandler Act provides that the judge shall divide the creditors and stockholders into classes "according to the nature of their respective claims and stock".[31] Corresponding English and Canadian statutes which provide for

[30] House of Commons Debates, Canada, 1932–33, Vol. V, 4723.
[31] 52 Stat. 899 (1938); 11 U.S.C., s. 597 (1946).

votes by classes have uniformly been treated as meaning classes so selected.

This conclusion is supported by practical considerations. I will endeavour to show later on that there should be a requirement that the creditors and shareholders exercise their voting rights bona fide in the interests of the class. It would be illogical to put persons with obviously conflicting interests into one voting group, as that would undoubtedly result in sacrificing the rights of the minority. The danger of such a course may be amply illustrated by reference to the first important decision under the C. C. A. A.[32] In that case all secured creditors had voted together regardless of interest, and although the required majority of the votes was in favor of the scheme, less than three-fourths in value of the bondholders had approved it. On this ground the court refused its sanction, stating that the parties must be divided on the basis of interest.

For these reasons the court should examine the nature of the claims of the creditors in order to classify them properly. For example, no two secured creditors should be grouped together unless their security is on the same or substantially the same property and in equal priority. Further divisions may be made on the basis of other legal preferences or according to whether the claim is liquidated or unliquidated, absolute or contingent. It would of course be impractical to classify them according to whether they also own shares or other interests in the company or on the basis of other extraneous interests because these things are too indefinite and would be different in the case of almost every individual. However, classification of the creditors and shareholders according to their interests in the company must be made before the court can proceed to direct the sending of notices or the holding of meetings.

Direction of Meetings

When the parties have been classified it becomes necessary to direct meetings and get the consent to the proposal of all classes "affected". Under this criterion the question arises whether it is necessary to obtain the approval of junior classes of shareholders or creditors who have no remaining equity in the enterprise, even at a liberal going concern valuation. In the United States, under the Chandler Act, it is not necessary.[33] That rule makes it much more practical to invoke the absolute

[32] *Re Wellington Bldg. Corp. Ltd.*, [1934] O.R. 653.
[33] *Supra*, note 31, ss. 579, 616 (7) and (8), 621.

priority doctrine, since it dispenses with the necessity of paying such classes for a statute-created nuisance value, — their power to vote on the proposal. I would suggest that it would be likewise desirable not to require meetings of such classes under the Canadian Act. However, it is doubtful whether under the C. C. A. A. and the Dominion Companies Act as they now stand this procedure may be followed, because under section 123 of the latter a meeting must be directed of each class of shareholders whose rights are *affected* or *cancelled*, and the necessary vote of each class obtained, before the court may sanction the arrangement. While it might be strongly argued that the rights of a junior class with no equity are not "affected" by a plan which excludes them, since they had nothing but worthless shares or claims, it can hardly be contended that they are not "cancelled". It therefore appears that meetings must be directed of all such classes of creditors and shareholders.

Although it cannot be contended that the classes should be allowed to vote in one poll, there is some difference of opinion as to whether they should be directed to meet together at the same time and place. In a recent House of Lords case[34] involving a reduction of capital under the English Companies Act, Lord Maugham criticized the holding of a joint meeting of different classes of shareholders, since the presence of persons with opposing interests may seriously embarrass members in the discussion and interfere with their full freedom to express their opinions. Since this objection had been waived by all parties interested, and the classes had voted separately, it was held not to be a bar to approval of the scheme. In *Re Wellington Building Corporation Limited*,[35] an Ontario case under the C. C. A. A., Kingstone J., although dubious about the propriety of a joint meeting, said by way of *dictum* that it may have been adequate. Another Ontario judge in dealing with an arrangement among shareholders stated that there was nothing wrong with two classes of shareholders meeting together to consider it.[36] In a later case involving a scheme under the Ontario Companies Act, Middleton J.A. cited Lord Maugham with approval and stated that it was dangerous to hold meetings of the different classes together, but that "departure from this is not necessarily fatal if proper precautions are taken".[37]

[34] *John K. Carruth et al. and Imperial Chemical Industries Ltd.*, L.R. [1937] A.C. 707 (H. of L.).
[35] [1934] O.R. 653, at p. 660.
[36] Orde J.A. in *Re Secord Standard Royalties Ltd.*, (1930), 66 O.L.R. 288, at p. 297.
[37] *Re Langleys Ltd.*, [1938] O.R. 123, at p. 128.

In the United States there is no requirement of separate meetings and all that is necessary is that the plan be accepted in writing by the required majority of each class.[38] As opposed to Lord Maugham's opinion,[39] it might be contended that a joint meeting, if not too large, would provide each class with a better opportunity to understand the viewpoint of the other and to arrive at a suitable compromise or arrangement. In many cases this argument might well be more persuasive in favor of directing classes to meet together than the resulting shyness of speakers would be against it. Since the words of the Canadian statutes do not solve this problem, since it would seem that the holding of a joint meeting is not fatal to the ultimate approval of a plan, and since there is conflicting authority as to the advisability of holding separate meetings, it would appear to be a problem, in the solution of which the court may properly use its discretion upon considering the particular advantages and disadvantages of each possible course in the case under consideration.

The judge in ordering the holding of the meetings will ordinarily direct that notice of the meeting be given long enough in advance in order that the parties or their advisers will be able to familiarize themselves with the problems, make a considered decision as to how they will vote, and then have a reasonable opportunity of exercising their franchise. The meeting should, of course, be held in such a place that as many members as possible of each class, and holding the maximum proportion of the claims or shares, can attend in person. It ought also to be convened in a room sufficiently large to accommodate all the persons likely to attend.[40] These are precautions which appear obvious, but because of the silence of the statute on these matters they can easily be overlooked, so as to prejudice seriously the success of the reorganization.

Conditions Precedent to Sanction of the Plan

When a compromise or arrangement comes to the court for approval under section 5, the judge will have no jurisdiction to sanction it unless there has been substantial compliance with the words and spirit of the statute.[41] Before considering the plan on its merits, he will have to satisfy himself that the

[38] 52 Stat. 892 (1938); 11 U.S.C., s. 579 (1946).
[39] *Supra*, note 34.
[40] *Cf.* Gold: Preference Shareholders in the Reconstruction of English Companies, (1943–44), 5 U. of Tor. L. J. 282, at p. 312.
[41] *Re Dairy Corporation of Canada Limited*, [1934] O.R. 436, at p. 439.

creditors and shareholders have approved it in the correct manner and under appropriate conditions. It should first be established that there was no fundamental impropriety in the order directing the meetings, as to classification of the creditors or otherwise. It will then be necessary for the court to see that the applicants have performed their responsibilities, the most obvious of which is to comply with the particulars of the order directing the meetings. But they also have other duties, no less important, as to which the Act and the order may be completely silent.

Circulars mailed to the parties

It is ordinarily one of the duties of the proponents of a plan to send out circulars to the shareholders and creditors who are entitled to attend the meetings. These documents will contain information concerning the present condition of the company and the rights of the parties, as well as the arrangement proposed. It is convenient at this point to consider what should be included in these circulars. It is hoped that such a discussion may aid counsel for the proponents in performing his responsibilities. It may also help the court in deciding whether the parties were informed fully and correctly enough to have made an intelligent decision. If this is not the case the court may find that it is unable to sanction the arrangement.

There are special reasons in reorganization cases for requiring that full information be given the parties who are to vote, and who will by their decision bind not only themselves but dissenters. It is often true that the proponents of the reorganization, who prepare the circulars, are holders of one class of shares which may stand to gain under the proposal at the expense of other security holders and claimants. They are in such a position that they can hire experts, and also have the advantages of concentrated action and a full knowledge of the situation, which could not be acquired by the creditors and preferred shareholders who are scattered all over the country.[42] It is axiomatic that the parties will be unable to exercise properly their voting power or protect adequately their interests unless they are as completely and fairly informed as possible as to the proposal, the facts and the law.

In the United States there is a better opportunity to meet this problem than in Canada or Britain because of the necessity

[42] *Cf.* S. E. C. Report on Protective and Reorganization Committees, Part VIII, pp. 309–13 (1940); *Re Consolidated Film Industries Inc.*, S. E. C. Release No. 903 (Oct. 22, 1936).

for preliminary hearings by the court and by the Securities and Exchange Commission on the merits of the plan before it is placed before the creditors and stockholders.[43] The Chandler Act provides that there shall be mailed to each interested party a copy of the proposed plan or plans and a summary of each. There must also be enclosed the court's opinion approving the scheme or a summary of it and the report of the Commission or a summary of the report approved by it, and such other matters as the judge thinks necessary or desirable. All of these documents must be approved by the court except the S. E. C. report and the summary of it.[44] Although it is not possible to provide such complete and independent information under the Canadian statute, an effort should be made to impose requirements of suitable substitutes.

A statement of the provisions of the proposal should of course be sent and it would be desirable to enclose a summary of it which can easily be understood by a layman. Maugham J. in a leading English case stated that even though there was no obligation under the English Act to send out an explanatory circular at all and no power of the judge to order one sent, the absence or incorrectness of one would be a ground for refusing to sanction the plan. It should state all of the main points of the scheme and the significance of each so that the creditors and stockholders can form a proper judgment, and it ought to be very closely scrutinized by the reviewing court. He suggested that where complex matters are involved each class should be permitted to appoint one or more of its members to make an investigation and issue a report to the class.[45] This task could be done for the bondholders by the indenture trustee, and if the company is in bankruptcy or liquidation, it could be done for all creditors by the bankruptcy trustee or liquidator. Whether or not this particular suggestion by Maugham J. is followed, it is usually considered proper in the reorganization of any company large enough to bear the expense, for a full report to be made on the merits of the proposed plans by at least one independent expert and submitted together with the plans and summaries of them to the creditors and shareholders a reasonable time in advance of the meeting.

There will ordinarily be sent to the parties, in addition to this report or included in it, complete factual information as to the present business condition of the company and the relative

[43] 52 Stat. 890, 891 (1938); 11 U.S.C., ss. 572, 574 (1946).
[44] *Ibid.*, s. 575.
[45] *In re Dorman, Long & Co. Ltd.*, L.R. [1934] Ch. 635, at pp. 670–2.

positions of the various classes of claimants and members with respect to it. Its scope should extend to every matter which a man would need to know in order to arrive at a proper decision. This would include all of the facts, hereinafter referred to, which the court will consider in looking at the plan on its merits. The balance sheet and a profit and loss statement for the relevant years would obviously be required.[46] Also the liabilities should be listed separately in detail and in such a way as to show their relative priorities. In addition there should be an appraisal of the liquidation value of the assets, and a statement showing what proportion of its claims each class would receive upon an immediate liquidation, assuming that appraisal to be correct. There should also be an estimate, founded on full information, of the probable future earnings of the reorganized company, and a statement, based on those figures, showing the prospective value of the securities which each member would receive under the proposed plan and the interest or dividends he would likely receive. In addition the parties should be given an indication of the reasons for the present unfortunate condition of the company and of the factors upon which its future success will depend. The report ought to include expert opinions as to what is the probability of the economic rehabilitation of the business. If the interest of the consuming public or of large numbers of employees is involved, there should be a statement of the existence and extent of that interest. No factor should be omitted which might affect the manner in which the parties will vote.

The circular should not only be complete but also accurate and straightforward. In one English case[47] the petition for approval was denied because the circular was misleading in that it would lead the reader to believe wrongly that the trustee which recommended the plan was independent and had nothing to gain from the continuation of the company in business. The trustee in that case was a bank which in fact stood to obtain considerable business if the reorganization were put through. The court should carefully scrutinize the circular for such inaccuracies, and for obscurity which may be even more reprehensible than inaccuracy because less easily demonstrated and proved.

To avoid these pitfalls all of the material to be sent to creditors and stockholders ought to be compiled in a compact and readily understandable form. If the company is sufficiently large to bear the expense, this should be done by competent and truly

[46] *Re National Grocers Company Limited*, [1938] O.R. 142, at p. 154.
[47] *In re Dorman, Long & Co., Ltd.*, L.R. [1934] Ch. 635.

independent experts. Their impartiality could be ensured by having them nominated by agreement among the representatives of all the classes of creditors and shareholders affected. In the Abitibi case the Ontario government appointed a committee of three men to negotiate a compromise plan, and presumably to prepare or approve documents in connection with it. A principle to be kept foremost in view in selecting such experts is that they should have no personal economic interest in the success or failure of the reorganization. If the size or economic position of the company doesn't warrant the hiring of such persons, the principles of full and correct information and simplicity should be followed by whoever is promoting the plan. They may use their powers of reason and persuasion to the full, but ought not to resort to concealment of facts or to deception, either intentionally or as a result of carelessness.

Care must be taken not to misinform the voters as to the law. This point was raised in *Re Langleys Ltd.*,[48] where the notice declared that proxies would be voted in favor of the scheme unless the party signing it stipulated to the contrary. That statement failed to take into account the statutory provision that the proposed compromise or arrangement may be altered or modified at the meeting, and it placed the person receiving the proxy in the position of not being able to vote for any modification of the plan without violating the condition of the proxy. The court held that the statute did not contemplate a meeting at which the proposal could not be altered, and for this reason it could not sanction the scheme. In another case[49] the notice stated that the proxies must be received by two o'clock on the day of the meeting in order to be effective. In refusing to approve the arrangement, the Ontario court stated that there was nothing in the statute which authorized such a notice and that this was fatal. A statement based on a misconception of law may be as much a misrepresentation in some circumstances as a misstatement or omission of fact.

Proxies

The proxy forms sent out should be considered particularly carefully because of the difficulty of absent persons being adequately represented. The proxy system has been severly criticized both generally and in connection with reorganization schemes.

[48] [1938] O.R. 123.
[49] *Re Dairy Corp. of Canada, Ltd.*, [1934] O.R. 436.

It has been suggested that it be replaced by a referendum,[50] but this is impossible under the existing statutory provision that the proposed arrangement may be altered or modified at the meeting. For this reason a person voting by proxy cannot directly pass on the merits of the plan adopted, but necessarily delegates his discretion to the designated person. In many companies large numbers of the creditors or shareholders reside at points all over the country or the world, and would not know anyone present, or if they did, would not desire to entrust their voting rights to such persons. In such a case it would be apparent that a considerable number of the parties affected by the scheme would have no way of exercising their franchise effectively. At the same time their proxies may be decisive in the election. In the United States this situation has been avoided by making it necessary that the final form of the plan be arrived at before being submitted to the creditors and stockholders, and that it be accepted in writing by or on behalf of the required majority. Although it is not possible under the present Canadian statute to give the parties as effective a franchise as under the American provision, some steps can be taken in that direction.

The inequitable effects of the proxy system may be minimized by imposing requirements as to the proxy forms which are sent out to the parties and the literature which accompanies them. In an important reorganization case in Great Britain the court found that there was no irregularity in naming an agent in the proxy form before it was sent out to the voters.[51] This holding has been disagreed with by two Canadian courts which have stated that if the names of persons are inserted in advance by the proponents of the plan, it is a fatal objection which will justify the court in refusing its sanction.[52] It would seem that these decisions were probably sound because a form already filled out would tend to induce many people to sign it without a thorough consideration of the problems and by their votes to deprive others of their rights.

A suggestion may be made here as to a practical method of meeting the proxy problem. Under this scheme the proponents of the plan would prepare a circular containing the names of

[50] Gold: Preference Shareholders in the Reconstruction of English Companies, (1943-44), 5 U. of Tor. L. J. 282, at p. 313.

[51] *In re English, Scottish and Australian Chartered Bank*, L.R. [1893] 3 Ch. 385 (C. of A.); although it was stated by Maugham J. in a later English case that this practice was inadvisable. *In re Dorman, Long & Co. Ltd.*, L.R. [1934] Ch. 635.

[52] *Re Dairy Corp. of Canada Ltd.*, [1934] O.R. 436, at p. 441; *Re National Grocers Ltd.*, [1938] O.R. 142, at p. 150.

persons identified with each of the principal points of view concerning the reorganization together with a short statement of the position each takes. A copy of this would be sent to each creditor and shareholder who has a vote, together with a proxy form in which no name is inserted, and which contains a blank space for any stipulations which he may wish to make as to the manner in which the proxy shall be exercised. This form might alternatively contain the names of all the men named in the circular, with a marginal direction to the voters to cross out all but one of them. A system such as this would require that members give the matter at least some thought before voting on a matter which might deprive others of their rights. It would also give them as much opportunity as is possible under the present statutes to use their franchises effectively, and would remove any possibility of the court refusing its sanction on the ground that the proxy form is irregular.

Required majority

There seems to have been considerable uncertainty as to what sort of majority is required at the meeting to approve the compromise or arrangement under the terms of section 5 of the C.C.A.A. and other similar provisions. As has already been mentioned, the necessary majority of each and every class affected must vote for the plan before it can be sanctioned by the court. The Exchequer Court once said by way of *dictum* that absence from the meeting is a vote against the scheme.[53] An Ontario judge reluctantly decided in another case that this was not so and that even though the plan was not approved by a majority of all parties affected, it was sufficient that those present at the meeting had overwhelmingly voted for it.[54] This point has also been the subject of considerable litigation under other statutes. In particular, Manitoba[55] and Saskatchewan[56] courts have disagreed as to whether, under section 122(2) of the Dominion Companies Act, the requirement is for approval of the arrangement by three-fourths of all the shares of each class or merely three-fourths of those present at the meeting. There was a similar disagreement as to the interpretation of section 13 of the Bankruptcy Act between Ontario and Quebec courts.[57]

[53] *The King* v. *Kussner*, (1937), 18 C.B.R. 58 (Exchequer Court).
[54] *In re Bilton Bros. Ltd.*, (1940), 21 C.B.R. 79 (Ont.) (Urquhart J.).
[55] *In re Western Grocers Ltd.*, [1936] 2 W.W.R. 81 (Man.) (three-fourths of all shares).
[56] *In re Provincial Apts. Ltd.*, [1936] 2 W.W.R 327. (Sask.) (three-fourths of those present).
[57] *In re Steckley*, (1942), 24 C.B.R. 186 (Ont.); *In re Adlington and Pope and Duclos*, (1943), 25 C.B.R. 63 (Que.).

This confusion seems to have arisen from ambiguities in the wording of some of these statutes. Sections 122 and 123 of the Companies Act both use the expression "three-fourths of the shares of each class represented and voted", and the question is whether "represented and voted" refers to "shares" or "class". The C.C.A.A. makes necessary the approval of "a majority in number representing three-fourths in value of the creditors, or class of creditors, as the case may be, present and voting either in person or by proxy at the meeting or meetings". There would appear to be little room for misunderstanding these words, particularly since they are taken almost verbatim from section 153 of the English Companies Act which has been uniformly interpreted as requiring approval of the plan by a three-fourths majority of those actually voting at the meeting.[58] In addition it may be argued that it is reasonable to assume that those who do not vote are content to be bound by the decisions of those who do, and that under the C.C.A.A. and the Dominion Companies Act, the same principle should govern as in elections of labor union and legislative representatives, and as in democratic referenda. Because of the usual apathy of creditors and investors generally,[59] it would otherwise be virtually impossible to effect a reorganization in many cases.

Vote must be in good faith

It is also a condition precedent to the sanction of an arrangement under the Act that the members of each class who voted in favour of the plan did so in good faith. It has been decided on more than one occasion that where any claimant votes in favour of an arrangement between a debtor and its creditors as a result of an agreement under which he gets a secret advantage over the others his vote is of no effect.[60] This is so even if the judge has later approved the arrangement in ignorance of the secret contract.[61] The Privy Council has held that where a vote on a reorganization plan was being taken under the terms of a mortgage trust deed, and one important bondholder was induced to vote for it by giving him a special concession of shares that the others didn't receive, his vote was ineffective. Viscount Haldane in delivering their Lordships' judgment said that "the power

[58] *In re Alabama, N. O., T. & P. J. Ry. Co.*, L.R. [1891] 1 Ch. 213 (C.A.); see also *Re Dairy Corporation of Canada Ltd.*, [1934] O.R. 436, at p. 439.

[59] *See In re English, Scottish and Australian Chartered Bank*, L.R. [1893] 3 Ch. 385, at pp. 396–7 (C.A.).

[60] *Hochberger et al.* v. *Rittenberg*, (1916), 54 S.C.R. 480; *La Prévoyance* v. *Giroux et al.*, (1932), 14 C.B.R. 174 (Quebec, Court of King's Bench).

[61] *Brigham* v. *La Banque Jacques Cartier*, (1900), 30 S.C.R. 429.

given must be exercised for the purpose of benefiting the class as a whole, and not merely individual members only".[62] If it can be established that members whose votes were decisive would not have voted for the arrangement if it had not been for considerations other than the interest of the class, the court will have no option but to refuse to sanction the scheme.[63]

In the leading English reorganization case, the holders of £330,000 of first debentures who voted for the plan also held a considerable number of second debentures. The court held that although the statute does not allow their being denied the franchise, the complicated nature of their interest will induce the court to scrutinize the merits of the plan more closely with that fact in mind.[64] For this reason the court should have full information as to any creditors or shareholders who are members of more than one of the classes affected by the reorganization. It may be desirable that those members of a class who also hold securities of another class and those who do not should vote in separate groups at the meeting.

The American Chandler Act provides that "if the acceptance or failure to accept a plan by the holder of any claim or stock is not in good faith, the judge may, after hearing upon notice, direct that such claim or stock be disqualified for the purpose of determining the requisite majority . . .".[65] Under this provision a vote against the scheme could be outlawed as well as one in favour of it. Although I can find no English or Canadian case in which that point was raised, I submit that the principle of *British America Nickel Corporation Limited et al, and M. J. O'Brien, Limited*[66] would be equally applicable in that case, and that if members of any class voted against the proposal because of interests other than those of the class, their votes could properly be disregarded.

It is well established that a judge, in reviewing a compromise or arrangement, should first look to see that the provisions of the statute have been complied with and that all other conditions precedent have been satisfied. He must also assure himself that nothing has been done which is not authorized by the statute.

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[62] *British America Nickel Corp.* Ltd *et al.* v. *M. J. O Brien, Ltd.*, L.R. [1927] A.C. 369, at p. 371 (P. C.).

[63] *Cf. In re Wedgewood Coal & Iron Co.*, L.R. [1877] 6 Ch. D. 627; *John K. Carruth and Imperial Chemical Industries Ltd.*, L.R. [1937] A.C. 707, 769. (H. of L.).

[64] *In re Alabama, N. O., T. & P. J. Ry. Co.*, L.R. [1891] 1 Ch. 213, at p. 239–40 (C.A.).

[65] 52 Stat. 894 (1938); 11 U.S.C. s. 503 (1946).

[66] L R. [1927] A.C. 369, (P.C.).

If the answers to these questions are favorable, he will have jurisdiction to look at the plan on its merits. For this purpose, Canadian courts will desire to acquire full information as to the position of the company and each class of creditors and shareholders, and to consider the plan in the light of the principles of reorganization.

Merits of the Reorganization Plan

The motive which has induced the courts to consider the merits of reorganization schemes is the need for protection of the interests of the public and the rights of minority creditors and shareholders. Even if the conditions precedent have been fully observed there may be some defect in the proposed plan which makes it inadvisable to put it into effect. The influence of the management or the votes of some of the parties may have been used in bad faith or for the purpose of overbearing the interests of the minority or of senior classes, even though that fact is not susceptible of proof. On the other hand a disapproval of a plan may unreasonably prolong or entirely defeat the reorganization procedure. The permanent unfortunate effects of a court veto at this point may be more serious than the inequities in the plan agreed upon. For these reasons the court must look at the proposal very carefully and decide whether it should or should not be sanctioned.

It would appear that although the C. C. A. A. and section 123 of the Companies Act were fashioned along the general lines of section 153 of the English Companies Act, there is no reason to assume that the courts are limited to application of the English standard as to the fairness of a plan. There is nothing in the history of these Canadian statutes to indicate that the legislators had in mind any particular test which was to be applied or that they had any intention other than to grant our judges a discretion to sanction or not to sanction a proposal and to devise their own rules and criteria for the purpose.

The English rule of fairness is the one which was originally stated in the *Alabama* case, — that the court "must be satisfied that the proposal was at least so fair and reasonable, as that an intelligent and honest man, who is a member of that class, and acting alone in respect of his interest as such a member, might approve of it".[67] The sanction will be refused only if the scheme cannot possibly be for the benefit of one of the

[67] *In re Alabama, N. O., T. & P. J. Ry. Co.*, L. R. [1891] 1 Ch. 213, at p. 247. (C.A., Fry L.J.).

classes. I have suggested that a practical device which might be used in applying this criterion would be to make, with respect to each class, comparative valuations of what the members would likely receive upon an immediate liquidation and what they would stand a reasonable chance of obtaining under the scheme. Theoretically, under this test, if the latter figure is larger than the former for every member, the plan is not unfair.

I would suggest, however, that the court should go further and examine the way in which the plan would distribute the excess of going concern value over liquidation value. A judge who is entrusted with the protection of the rights of the parties and particularly the minorities will wish to inquire as to the fairness in all respects of the proposed distribution of securities. He will determine what if any special recognition has been given to any class of shares, a substantial proportion of which is held by the management, and whether this is justified as an inducement to the management to participate in the reorganization and contribute to the future welfare of the company. Subject to this he may well insist that priority rights of senior classes be fully recognized in the reorganized company before any participation is allowed to junior classes. If it is objected that this will make impossible the consummation of the plan because the consent of the junior classes is required, it may be answered firstly that this practical difficulty should not be permitted to authorize the confiscation of the legal rights of priority, and secondly that there would be no more effective way of bringing this defect in the statute to the attention of Parliament for correction.

However, the requirements for maintenance of priorities should not be so stringent that it would be unduly difficult for the parties to bring about a reorganization where the company would be greatly benefited by it and where the plan represents a bona fide and creditable attempt to accomplish the result fairly to all parties. The room for difference of opinion as to the future earnings of the company would make it desirable that the court should not reject a scheme, if the allocation of new securities is based upon a valuation which was made in good faith and is not unreasonable. In other words, "some play must be allowed for the joints of the machine".[68]

It is also fundamental to the equitableness of a proposal that a sacrifice or modification must be borne proportionately

[68] *Missouri, Kansas and Texas Ry. Co.* v. *May*, 194 U.S. 267, at p. 270 (1903). The expression is that of Mr. Justice Holmes.

by all members of any one class affected. In one case in which the directors were to be given broad powers, including the right to infringe later on the rights of the minorities, the sanction was withheld.[69] It may be that, if justified by very special circumstances, a plan might be approved under which members of one class would "not all (be) paid in the same coin or in coin of the same denomination", if there were "no real inequality in the treatment of (the) class". However this would be the exception rather than the rule.[70]

In considering the merits of a plan, a court will wish to determine whether the plan is feasible and likely to be successful in accomplishing its purposes. It is even more important to consider this rather than the fairness of the scheme, because the feasibility is a matter upon which the majority of creditors and shareholders are even less in a position to judge when they vote, but which is vital to the entire reorganization. Therefore the court with full information should scrutinize the plan carefully from the viewpoint of feasibility along the lines mentioned earlier.

Conclusion

In considering the merits of an arrangement agreed to by the parties, as well as in considering whether conditions precedent have been performed, a judge will have a difficult task in balancing interests and considerations.

To exercise his discretion for the furtherance of justice and utility the judge will require a high standard of excellence in a reorganization plan. He will not wish to approve an inequitable or unworkable scheme. He will be reluctant to sanction an arrangement which was not fairly presented to the parties before they agreed to it or which otherwise failed to comply with the conditions which have been indicated as desirable.

On the other hand it may be a serious hardship to refuse approval. The urgency of the reorganization may require relaxation of some standards. The facility of correction of an error may influence the determination of whether it will be held fatal. The amount of work done and the extent of agreement attained by the proponents will prevent the court from lightly vetoing the arrangement at this stage.

Since the facts will vary immensely from case to case, it is impossible to lay down any hard and fast rules for deciding cases

[69] *Re Secord Standard Royalties Ltd.*, (1930), 66 O.L.R. 288.
[70] *Cf. The British & American Trustee & Finance Corp.* v. *Couper*, L.R. [1894] A.C. 399, at pp. 415–16 (H. of L.).

under the C.C.A.A. All that can be suggested is that the court fully understand all of the facts and considerations involved in each instance. The seriousness of the objections to the plan and the procedure followed will be weighed against the harmful effect of refusing to sanction the proposal. The court ought to balance these factors carefully and reach a result which is reasonable and which is designed to further the purposes of the C.C.A.A. and develop the Canadian reorganization law upon sound principles. This latter object can be attained only if written reasons are given for the decisions.

Counsel for the proponents of an arrangement are placed by the C.C.A.A. in a position of heavy responsibility in working out a plan and in carrying out the procedure of having it adopted. This responsibility is not only to their clients but to all persons with interests in the company. They can by a diligent and informed performance of this duty render the dilemma of the court less difficult and make valuable contributions to our reorganization law.

ENFORCING THE LAW

We are all agreed that *the law is not good:* for that, I presume, is undoubtedly the idea of a law that ought not to be executed. The question, therefore, is, whether in a well-constituted commonwealth, which we desire ours to be thought, and I trust intend that it should be, whether in such a commonwealth it is wise to retain those laws which it is not proper to execute. A penal law not ordinarily put in execution seems to me to be a very absurd and a very dangerous thing. For if its principle be right, if the object of its prohibitions and penalties be a real evil, then you do in effect permit that very evil, which not only the reason of the thing, but your very law, declares ought not to be permitted; and thus it reflects exceedingly on the wisdom, and consequently derogates not a little from the authority, of a legislature who can at once forbid and suffer, and in the same breath promulgate penalty and indemnity to the same persons and for the very same actions. But if the object of the law be no moral or political evil, then you ought not to hold even a terror to those whom you ought certainly not to punish: for if it is not right to hurt, it is neither right nor wise to menace. Such laws, therefore, as they must be defective either in justice or wisdom or both, so they cannot exist without a considerable degree of danger. Take them which way you will, they are pressed with ugly alternatives. (Edmund Burke: Speech on a Bill for the Relief of Protestant Dissenters. 1773)