

**“UN-ROLLING” CCAA SECTION 11.2**

**An Analysis of the Treatment of Roll Ups in DIP Financing in  
Canada**

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## Introduction

COVID-19 has caused unprecedented stress on global and Canadian economies evidenced by market turmoil and historically high unemployment rates. Notwithstanding various government assistance programs, many companies are in a state of deep financial distress. The objectives of the *Companies' Creditors Arrangement Act* (“CCAA”) are to (i) preserve going concern value, (ii) maximize creditor recovery; and (iii) minimize the potential damage to employment and communities that may be caused by bankruptcy.<sup>1</sup> When an insolvent company files for creditor protection under the CCAA, the company often requires liquidity to allow for continued business operations during the reorganization process. Commonly, relief is provided by debtor-in-possession (“DIP”) financing.<sup>2</sup> The availability of DIP financing was codified following amendments made to the CCAA in 2009. Providers of DIP financing are permitted to apply for an order declaring that part of the debtor’s property be subject to a charge, in exchange for advancing funds post-filing. However, the charge may not secure an obligation that exists before the order is made pursuant to section 11.2.<sup>3</sup> Therefore, a prevalent issue – particularly in cross-border insolvencies – is the judicial treatment of roll ups. A roll up is an arrangement in which prefilings debt is paid back using proceeds from the DIP facility<sup>4</sup> and is currently not available in Canada under the CCAA. By analyzing relevant Canadian jurisprudence, this paper intends to argue that the repudiation of roll ups in Canada should be discontinued so as to better adhere to the objectives of the CCAA given the current economic environment.

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<sup>1</sup> Government of Canada, *You Owe Money – Restructure your Business through the Companies' Creditors Arrangement Act (CCAA)* (Canada: Office of the Superintendent of Bankruptcy Canada, 2015) <<https://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br03125.html>> accessed 22 April 2020.

<sup>2</sup> Practical Law Canada Finance, “DIP Financing: Overview”, in *Thomson Reuters Practical Law* <<https://ca.practicallaw.thomsonreuters.com>> [https://perma.cc/7AJX-R9F5].

<sup>3</sup> CCAA, RSC 1985, c C-36, s 11.2(1).

<sup>4</sup> Practical Law Canada, “Glossary”, in *Thomson Reuters Practical Law* <<https://ca.practicallaw.thomsonreuters.com>> [https://perma.cc/7AJX-R9F5].

## **DIP Financing**

DIP financing refers to situations where insolvent debtor companies have obtained additional credit financing to enable them to carry on business while operating under CCAA protection. Pursuant to section 11.2, on application by a debtor company and on notice to the secured creditors who are likely to be affected by the charge, a court may make an order declaring that the company's property is subject to a security in favour of a person specified in the order who agrees to lend the company an amount approved by the court as being required by the company, having regard to its cash-flow statement.<sup>5</sup> By extension, a DIP lender is often granted "super-priority" status over the claims of other creditors in the event that the restructuring is unsuccessful.<sup>6</sup> However, the security or charge may not secure an obligation of the DIP lender that existed before the order was made.

Given the current market downturn, lenders may struggle to decide whether they should provide additional financing to a debtor company without greater security.<sup>7</sup> There is risk required to capture going concern value, whereas liquidation would ensure par recovery. To lessen risk for the lender by improving the priority position of pre-filing debt, the inclusion of a roll up a in DIP financing arrangement may be a practical solution for both lender and debtor.<sup>8</sup>

## **Roll Ups**

A roll up is a type of DIP financing arrangement in which prefiling debt – or a portion thereof – is repaid using proceeds from the DIP loan facility itself.<sup>9</sup> Essentially, the prefiling debt

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<sup>5</sup> *Supra* note 3.

<sup>6</sup> Patrick Cleary & Brendan Craig, "DIP Financing Basics and Recent Case Law" (20 August 2014), online (blog): *Alexander Holburn Beaudin + Lang LLP Business Law Blog* <<https://canliiconnects.org/en/commentaries/29143>> [<https://perma.cc/PX5T-94X3>].

<sup>7</sup> Paul H. Zumbro, *DIP and Exit Financing Trends and Strategies in a Changing Marketplace* (United States: Aspatore, 2016) at 9.

<sup>8</sup> *Supra* note 2.

<sup>9</sup> *Ibid.*

is “rolled into” the post-filing credit. Among other protections, the prefiling loans cannot be compromised.<sup>10</sup>

Permutations of roll ups also exist, including creeping roll ups. In these arrangements, DIP proceeds are used to pay prefiling indebtedness. In other words, the cash receipts received by the debtor during the proceeding – which would typically be used to fund working capital – are applied to the pre-existing credit obligation.<sup>11</sup> Rather than being used to pay down the DIP facility, the pre-filing loan will be paid back, leaving the creditor with only the post-filing secured DIP loan.<sup>12</sup>

### **Canadian Jurisprudence**

Since the amendments to the CCAA in 2009, courts have continued to clarify the law with respect to DIP financing. In *Canwest Global Communications Corp (Re)*, the court reaffirmed that a DIP charge should not secure a pre-filing obligation.<sup>13</sup> However, it also held that the court must consider whether the amount provided is appropriate and necessary having regard to the debtors’ cash flow statement. The court expanded upon the list of factors that should be considered in approving an application in *Re Canwest Publishing Inc.* Additional factors that the court mentioned, included:

- (i) evidence of the reasonableness of the DIP financing terms;
- (ii) indications by the lender that they would be unwilling to provide a DIP financing facility without a priority charge; and

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<sup>10</sup> *Ibid.*

<sup>11</sup> Rupert Chartrand, Marc Wasserman & Sachin Kanabar, “Creeping Rollups: Repaying Pre-Petition Secured Debt Under the CCAA Under a DIP Facility” (21 March 2011), online (blog): *Weil Bankruptcy* <<https://business-finance-restructuring.weil.com/north-of-the-border-update/creeping-rollups-repaying-pre-petition-secured-debt-under-the-ccaa-under-a-dip-facility/>> [https://perma.cc/AE5L-GJXL].

<sup>12</sup> *Ibid.*

<sup>13</sup> *Supra* note 6.

- (iii) likelihood – not immediacy – that the entities in question would require the additional liquidity afforded by the DIP credit facility.<sup>14</sup>

By assessing applications on a balance of factors, Canadian courts appear to indicate that statutory provisions will not be narrowly interpreted and creative plans which provide the greatest likelihood of a successful restructuring will obtain approval.

Despite operating in contrast to section 11.2, there has yet to be judicial consensus as to the permissibility of roll ups in DIP financing. Through the general powers bestowed upon the courts under section 11, courts may make any order that they consider appropriate and have found creative solutions regarding statutory interpretation. To date, roll ups have been approved by Canadian courts as creeping roll ups and in recognition of United States (“U.S.”) DIP facilities under foreign recognition proceedings in cross-border insolvencies.<sup>15</sup>

### *Creeping Roll Ups*

A creeping roll up was notably used in *Re Cow Harbour Construction Ltd.*<sup>16</sup> Cow Harbour commenced a CCAA proceeding in order to stabilize its oil extraction operations and explore restructuring alternatives. Prior to filing, Royal Bank of Canada (“RBC”) provided Cow Harbour with a \$40.3-million line of credit. The terms of the companies’ agreement were breached. After commencement of the CCAA proceeding, RBC extended a \$15-million DIP facility to Cow Harbour whereby outstanding debt was to be repaid by means of a creeping roll up. In its analysis of the application, the Court reasoned that, as long as the DIP financing was used to fund the debtor’s business operations, section 11.2(1) was not violated by proceeds of the DIP facility being

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<sup>14</sup> *Ibid.*

<sup>15</sup> *Supra* note 2.

<sup>16</sup> *Cow Harbour Construction Ltd., Re*, (28 April 2010), Edmonton 1003 05560, EVQ10COWHARB (Alta QB).

used reduce the balance of secured pre-filing working capital. Therefore, pre-filing obligations could be repaid where security was not explicitly granted.

Subsequent case law has supported the permissibility of creeping roll ups in Canada. Creeping roll ups were approved by courts in both *Comark*<sup>17</sup> in 2015 and *Re: Golftown Canada Inc.*<sup>18</sup> in 2016 on the basis of existing ABL cash management structures. In November 2016, the Ontario Superior Court of Justice (“OSCJ”) approved a creeping roll up in *Performance Sports Group Ltd.*, *Re* on its own standing.<sup>19</sup> Taking into account the factors codified in the CCAA, Justice Newbould was satisfied that the DIP financing arrangement should be approved and believed – as did the monitor – that the intercompany charge was the best way to protect Canadian creditors as a whole. However, the Court reinforced section 11.2(1) and held that no advances under the facility may be used to repay pre-filing obligations. In this case, one of the facilities was a revolving facility and, under its terms, receipts from the operations of the debtor company post-filing could be used to pay down the existing facility.<sup>20</sup> Evidently, the trend of Canadian courts has been to exercise increasing discretion of section 11.2 demonstrated by routine approvals of creeping roll ups in DIP financing applications.

### *Cross-Border Insolvencies*

An increasingly frequent structure in cross-border insolvencies is to have a plenary filing in the U.S. under Chapter 11, with a recognition proceeding under part IV of the CCAA in Canada. As addressed earlier, roll ups are not prohibited by statute in the U.S. In fact, a study of 658 Chapter 11 filings by large public U.S. firms found that 60% obtained post-petition financing primarily

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<sup>17</sup> *Comark Inc., Re*, 2015 ONSC 2010, (SCJ) [Comark].

<sup>18</sup> *Re: Golftown Canada Inc*, Court File No.: CV-16-11527-00CL (OSCJ [Commercial List]).

<sup>19</sup> *Performance Sports Group Ltd., Re*, 2016 ONSC 6800 (SCJ [Commercial List]) [PSG].

<sup>20</sup> *Ibid.*

from pre-petition bank lenders.<sup>21</sup> Moreover, lenders with a prior relationship with the debtor company were found to be much more likely to offer DIP financing to smaller firms than new lenders.<sup>22</sup> By permitting roll ups, the U.S. has identified the presumptive source of financing and encouraged these lenders to extend additional credit so as to capitalize on the going-concern value of a business in the process of restructuring, notwithstanding that this may prevent other creditors from full recovery in the event of failure.

The statutory prohibition of roll ups in the CCAA is a fundamental difference between Canada and the U.S. However, perhaps recognizing the need for cross-border cooperation, Canadian courts have permitted recognition of roll-ups in these types of proceedings.<sup>23</sup> Pursuant to part IV of the CCAA, a roll-up may be granted in a cross-border proceeding where those proceedings have been recognized as foreign main proceedings.<sup>24</sup> For example, the court determined that approval of the DIP facility was appropriate and necessary in both *Xinergy*<sup>25</sup> and *Colt Canada*.<sup>26</sup> A debtor seeking to have DIP financing recognized in Canada must still be prepared to demonstrate that there is no material adverse interest with respect to any Canadian interests. Where a DIP facility would be found prejudicial, it would be necessary to engage in a balancing of all contextual factors which would override the effect of the material adverse interest to Canadian interests in determining whether to approve the DIP financing.<sup>27</sup> Given

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<sup>21</sup> Kai Li and Wei Wang, “Debtor-in-Possession Financing, Loan-to-Loan, and Loan-to-Own (2016), <http://ssrn.com/abstract=2275635> at 1.

<sup>22</sup> S Dahiya, K John, M Puri, and G Ramirez, “The Dynamics of Debtor-in-Possession Financing: Bankruptcy Resolution and the Role of Prior Lenders”, 2000. See also I Hasan, G Ramirez and G Zhang, “Lock-in Effects in relationship Lending: Evidence from DIP Loans” <<http://ssrn.cm/abstract=1785685>> at 6.

<sup>23</sup> American Bar Association, “Insolvency and Restructuring – The Synergies and Challenges of a Canada-U.S. Insolvency Proceeding” (20 April 2016), online: *American Bar Association*: <[https://www.americanbar.org/groups/business\\_law/publications/blt/2016/04/03\\_manzer/](https://www.americanbar.org/groups/business_law/publications/blt/2016/04/03_manzer/)> [<https://perma.cc/L9LJ-74Nj>].

<sup>24</sup> CCAA, RSC 1985, c C-36, s 46.

<sup>25</sup> *Re Xinergy Ltd.*, 2015 ONSC 2692.

<sup>26</sup> *Colt Holding Company LLC*, 2015 ONSC 3928.

<sup>27</sup> *Supra* note 23.

the increasingly globalized nature of business and ratification of CUSMA, it would be expected that courts will observe increasing amounts of recognition proceedings that seek approval of roll up arrangements.

In many instances, it is difficult to see how any unsecured creditor would be harmed by roll up arrangements, as the only variable is timing, not certainty of repayment. This is evidenced in *Payless Holdings Inc. LLC, Re.*<sup>28</sup> In the context of an ABL roll-up, the pre-petition ABL facility is by definition over-secured when “in formula”<sup>29</sup> and secured creditors are simply entitled to the full value of their charge. Moreover, given that courts will grant DIP lenders a super-priority ranking, it seems contradictory to use “prejudicial treatment” as a reason for disallowing pre-filing claims to be treated as post-filing claims.

On April 20, 2017, the Court refused to accept the DIP financing facility in *Payless Holdings*.<sup>30</sup> Recognition of the DIP order had been opposed by Canadian landlords who, in the face of the use of a roll up, had not been offered comparable protection provided to that of other unsecured Canadian creditors. The Canadian Information Officer appointed by the Ontario Court reported that the creditors of Payless Canada Group (“Payless”) did not appear to be materially prejudiced and appeared to be the best alternative available to maintain operations of Payless as a going concern.<sup>31</sup> However, Justice Morawetz declined to recognize the facility. He reasoned that adequate protection must be provided to all Canadian creditors to ensure that they would not be adversely affected by the security granted. This decision demonstrated that the Court will not

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<sup>28</sup> *Payless Holdings Inc. LLC, Re*, 2017 ONSC 2321 (SCJ) [*Payless Holdings*].

<sup>29</sup> *Supra* note 7.

<sup>30</sup> *Supra* note 28.

<sup>31</sup> Michael Rotsztain, “Payless Canada Goes DIP-Less” (3 May 2017), online(blog): *Goldman Sloan Nash & Haber LLP* <<http://www.gsnh.com/payless-decision-ontario-court-sides-landlords-refuses-grant-dip-recognition-order/>> [<https://perma.cc/F2U7-CMKG>].

necessarily tolerate prejudicial treatment, even in the interest of international comity or pending liquidity needs.<sup>32</sup> At the same time, the decision implicitly indicated that the court will alter from the status quo, and a strict reading of section 11.2 in the CCAA, under the “right” circumstances.

Following the judgment, Payless was forced to file for protection for the second time in April 2019. Chief Restructuring Officer, Stephen Marotta, attested that the company emerged from its prior bankruptcy proceedings ill-equipped and left with too much remaining debt.<sup>33</sup> Despite profitable operations in Latin America and international franchises, the company has been forced to liquidate its North American assets. Arguably, Justice Morawetz’s decision prevented Payless from an opportunity to receive the financing needed to avoid bankruptcy. Moreover, the unsecured creditor group that the decision was originally made to protect may now be worse off. Payless had reportedly not paid rent for 220 of its Canadian units for February 2019, and it incurred an operating loss of more than US \$12-million last year.<sup>34</sup> With many other retailers closing stores in Canada, landlords are not in a strong position financially and remain unsecured creditors that rank behind secured creditors. In addition, approximately 2,400 workers will lose their jobs.<sup>35</sup> Thus, the court’s decision to deny the DIP order was not in line with the objectives of the CCAA and inhibited Payless’ ability to successfully restructure.

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<sup>32</sup> Rachel Bengino, “Roll-up DIPs: The other “shoe” drops” (20 October 2017), online (blog): *Thornton Grout Finnigan* <<https://www.tgf.ca/resources/publications/publication/roll-up-dips-the-other-shoe-drops>> [<https://perma.cc/2NLQ-DJB8>].

<sup>33</sup> Craig Patterson, “Payless Shoes to Shutter All 248 Canadian Stores”, *Retail Insider* (19 February 2019) <<https://www.retail-insider.com/retail-insider/2019/2/payless-shoes-to-shutter-all-248-canadian-stores>>.

<sup>34</sup> *Ibid.*

<sup>35</sup> *Ibid.*

In contrast, Toys R Us Canada filed for protection under the CCAA in September 2017 when its U.S. parent company filed for Chapter 11 bankruptcy.<sup>36</sup> The two entities shared a credit facility. The Court authorized the debtor companies to use certain proceeds from a new money DIP facility, secured by a Court-ordered DIP charge, to repay in full the debtors' pre-filing secured lenders.<sup>37</sup> It concluded that the Monitor obtained an independent legal opinion that the pre-filing ABL charge was valid, prior to all claims that will be primed by the court-ordered DIP and was not being used to improve the security of the pre-filing ABL lenders.<sup>38</sup> Of note, the DIP financing was provided by new third-party lenders, rather than the company's existing secured lenders. Today, the company is 100% Canadian-owned and operated, employs more than 4000 people and generates revenue of greater than \$1-billion per year.<sup>39</sup> The breathing room afforded by the CCAA proceeding and approved DIP order preserved value for stakeholders and provided the company with the resources to find a new buyer to continue operation.

## Recent Developments

CannTrust Holdings Inc. ("CannTrust") announced that it obtained CCAA protection from creditors in March 2020.<sup>40</sup> The company's license was suspended by Health Canada for the illicit production of cannabis earlier in the year. As a result, CannTrust has struggled to preserve its cash liquidity and faces an onslaught of class action lawsuits. Furthermore, Health Canada's ability to

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<sup>36</sup> Hollie Shaw, "Toys 'R' Us Canada wants you to know it is alive and well – and ready for its makeover", *Financial Post* (27 June 2018) <<https://business.financialpost.com/news/retail-marketing/toys-r-us-canada-wants-you-to-know-it-is-alive-and-well-and-not-going-anywhere-any-time-soon>>.

<sup>37</sup> *Re Toys R Us (Canada) Ltd.*, 2017 ONSC 6800 (SCJ [Commercial List]).

<sup>38</sup> Linc Rogers & Aryo Shalviri, "Canada: Retail Insolvencies in Canada Series, #4: Lender Perspectives" (08 October 2018), online (blog): *Mondaq* <<https://www.mondaq.com/canada/InsolvencyBankruptcyRestructuring/743424/Retail-Insolvencies-In-Canada-Series-4-Lender-Perspectives>> [https://perma.cc/7WLU-ME2P].

<sup>39</sup> *Supra* note 36.

<sup>40</sup> David George-Cosh, "CannTrust granted creditor protection as walls close in on embattled pot producer", *BNN Bloomberg* (31 March 2020) <<https://www.bnnbloomberg.ca/canntrust-granted-creditor-protection-as-walls-close-in-on-embattled-pot-producer-1.1415215>>.

conduct reviews has been delayed due to COVID-19 which has prevented the company from reclaiming its license. The company has stated that this has made it difficult to “attract new financing or a strategic partner”.<sup>41</sup> Given the uncertainty of the markets, it is not surprising that obtaining new financing poses a challenge – particularly, in a situation where it can be anticipated that a great deal of credit will be used to address impending litigation. The permissibility of roll ups would likely encourage existing lenders to extend additional funds in exchange for the condition that their pre-filing debt is bought out by the new DIP facility. Where CannTrust has no other reasonable prospective strategic partners, the ability to “roll up” pre-filing obligations would provide an advantageous negotiation tool to attract additional financing.

## **Conclusion**

The continued deterioration in both the Canadian and global economies due to COVID-19, combined with high corporate debt levels, suggests that the number of financially-distressed companies will continue to rise. Unfortunately, “the Canadian market for DIP lending remains strained, with only a handful of lenders willing to extend credit on onerous terms and at high interest rates.”<sup>42</sup> One solution may be to permit the use of roll ups in DIP financing arrangements. Roll ups have been routinely approved as creeping roll ups, as well as used in foreign recognition proceedings in cross-border insolvencies with the U.S. Thus, security for pre-filing credit is already being granted, albeit the ranking of the charge is not explicitly improved relative to other creditors in the aforementioned cases. In instances where DIP orders containing roll ups are denied, companies like Payless have failed to find alternatives. Roll ups may also give companies an opportunity to obtain additional financing in circumstances where existing lenders traditionally

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<sup>41</sup> *Ibid.*

<sup>42</sup> Logan Willis, “Cross-border Dip Issues in *Re InterTAN Canada Ltd.*”, online (pdf): *Insol International* <<https://www.goodmans.ca/files/file/docs/InterTAN%20Case%20Study.pdf>> [https://perma.cc/T7HP-6B63].

may cut their losses, such as with impending litigation. While it is admittedly important to protect the security of creditors from prejudice, the current judicial treatment of roll ups and inconsistent interpretation of section 11.2 makes the provision more confusing than clarifying. Therefore, contrary to section 11.2, the CCAA should permit roll ups so as to further opportunities for distressed companies to obtain DIP financing in an unprecedently, challenging economy, as well as encourage lenders with capital to extend credit. At minimum, amendments must be made to section 11.2 for clarification of potential carve-outs to the law. Only when Canadian legislation is adapted will the objectives of the CCAA – maximization of creditor recovery, preservation of going concern value and minimization of employment and community impact – be truly achieved.