Sweepstakes: contingent obligations and pre-filing set-off rights in insolvency

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The Ontario Superior Court of Justice's decision in *Carillion Canada Inc.* clarifies how the principles in Montréal (City) v. Deloitte Restructuring Inc. (Montréal) should be applied to contingent obligations that are only quantified after the debtor company files for creditor protection.

The main issue was whether the Companies' Creditors Arrangement Act (CCAA) preserved a creditor's contractual set-off rights with respect to payments that were made after the debtor filed for creditor protection, but originated from agreements that were entered into before the filing date. Ultimately, the court concluded that both obligations constituted pre-filing obligations and were therefore capable of being set-off in keeping with the decision in Montréal; however, the court also found that usually the ability to exercise such set-off rights will be subject to the stay of proceedings. In this particular case, and for the reasons summarized below, the stay did not prevent the exercise of the set-off.

Carillion provides important guidance to insolvency professionals regarding the application of Montréal, and clarifies how claims should be evaluated when they originate from obligations entered into before the filing date but are not ultimately paid until after filing occurs.

Background facts

Carillion Canada Inc. (CCI) was the Canadian subsidiary company of its U.K.-based parent company, Carillion plc. Carillion plc and its subsidiaries had a banking relationship with HSBC Bank in both Canada and the U.K. (HSBC and HSBC U.K., respectively) that was governed by various agreements entered into between 2002 and 2009, including:

- a global cash concentration arrangement with HSBC U.K., whereby all cash was swept on a daily basis to a bank account with HSBC U.K., resulting in a zero dollar balance at the start of every day in the Canadian bank accounts of CCI and its Canadian affiliates (Carillion Canada Group);
- letters of credit having a total value of C$6.8 million issued by HSBC in favour of CCI regarding several supplemental executive retirement plans; and

- various indemnity agreements, which expressly granted HSBC a contractual right to draw from CCI’s accounts to set-off any payments HSBC had to make under any of the letters of credit.

Carillion plc began experiencing cash flow challenges and therefore commenced liquidation proceedings in the U.K. on January 15, 2018. The Carillion Canada Group terminated its participation in the cash concentration arrangements immediately upon Carillion plc’s liquidation.

Due to the U.K. liquidation proceedings, the Carillion Canada Group sought protection under the CCAA on January 25, 2018. The Initial Order in the CCAA proceedings contained a stay provision prohibiting any person or entity from taking any enforcement steps against the Carillion Canada Group, and expressly prohibited the sweeping of any of their bank accounts.

Immediately following the granting of the Initial Order, CCI (being the main operating company of the Carillion Canada Group) took certain steps to implement a restructuring strategy that included ceasing making payments to the supplemental executive retirement plans. As a result, HSBC was obliged to fund $6.8 million of the supplemental executive retirement plans under the letters of credit. Two weeks later, after paying the funds under the letters of credit, HSBC notified CCI that it would be taking $6.8 million from CCI’s operating account in accordance with its set-off rights granted under the indemnity agreements. Despite the fact that HSBC was aware that CCI was subject to creditor protection and that the Initial Order had been granted, it nevertheless took the funds without waiting for a reply from CCI, asking the Monitor for permission or seeking leave from the court to debit the funds from CCI’s account.

Immediately after HSBC’s debit of CCI’s operating account, CCI and the Monitor transferred all the remaining funds into the Monitor’s trust account and subsequently to an operating account at another banking institution. CCI applied to the court for an order directing HSBC to return the $6.8 million, declaring that HSBC was prohibited from exercising set-off during the CCAA stay period.

The court’s decision

In evaluating whether HSBC could apply set-off in the circumstances, Chief Justice Morawetz reviewed the Supreme Court of Canada’s 2021 decision in Montréal, wherein the Supreme Court held that s. 21 of the CCAA preserves set-off rights in an insolvency so long as the cross-obligations are both pre-filing obligations. That is, the Supreme Court in Montréal held that CCAA s. 21 does not apply so broadly as to permit a creditor’s *pre*-filing claim to be set-off against a *post*-filing obligation owing to the debtor.

The question in *Carillion* then turned to whether the cross-obligations owing between CCI and HSBC were both pre-filing claims, or whether HSBC’s claim arose post-filing, in which case s. 21 would not have preserved HSBC’s set-off rights granted under the indemnity agreements.

CCI submitted that since HSBC was required to pay out the letters of credit after the Initial Order was granted in the CCAA proceeding, HSBC’s claim was a post-filing claim. Chief Justice Morawetz disagreed.

Morawetz held that the cross-obligations were both pre-filing obligations since they arose from agreements that were entered into before the Initial Order was granted. Further, he agreed with HSBC's submission that the mere fact that the cross-obligations were not quantified until after the filing date did not transform the claims into post-filing claims. Rather, the claims were contingent pre-filing claims, which are subject to the three-part test set out in *AbitibiBowater Inc.* for determining whether a contingent claim qualifies as a claim under the CCAA. The three parts of the test are as follows:

- There must be a debt
- The debt, liability or obligation must be incurred before commencement of the CCAA proceedings; and
- It must be possible to attain a monetary value to the debt, liability or obligation.

Morawetz found that HSBC's claim satisfied the factors set out in *AbitibiBowater* and therefore the set-off claim was preserved. Morawetz also noted that a plain reading of s. 19 of the CCAA, which sets out the types of claims that may be dealt with by a compromise or arrangement, clearly captures contingent claims, such as the claim advanced by HSBC.

Interestingly, Morawetz did find that while set-off rights may be preserved in certain circumstances in CCAA proceedings, the exercise of these rights is usually subject to the stay of proceedings. Indeed, Morawetz concluded that HSBC's set-off in this case was subject to the stay of proceedings granted by the Initial Order and that by unilaterally exercising these set-off rights, HSBC breached the stay and terms of the Initial Order. Nevertheless, Morawetz found there was no evidence that the exercise of HSBC's set-off rights prejudiced other creditors or jeopardized the Carillion Canada Group's restructuring efforts, and therefore allowed the set-off. Morawetz dismissed CCI's application, but granted a cost award of C$50,000 against HSBC (notwithstanding it was the successful party in the application) for having unilaterally exercised its set-off rights in the face of the stay provisions in the Initial Order.

Concluding comments

Set-off claims are inherently an exception to the distribution scheme set out in a CCAA plan of arrangement. Any unsecured creditor that successfully claims set-off is able to offset its obligations owing to the debtor on a dollar-for-dollar basis, whereas other unsecured creditors are typically forced to accept a significant discount. Given the obvious upside, creditors often attempt to offset *any* cross-obligations owing between themselves and the insolvent-debtor, irrespective of whether each of the obligations arose pre- or post-filing.

The cost award issued by Morawetz in this case is also an important reminder that creditors should not take remedies into their own hands in the face of a stay. One of the primary tools in restructurings is the stay of creditors' rights. It allows the debtor company to continue operating without fear of being driven into bankruptcy by its creditors while the restructuring is underway. As noted by the Supreme Court in Montréal, "[w]ithout such a [stay] period, there would be a free-for-all in which individual creditors would fight it out to enforce their rights without regard for the company's survival or the maximization of its liquidation value." Creditors that violate this fundamental pillar of restructuring law do so at their own risk.

In light of the outcome in *Carillion,* from a practical perspective, debtor companies who are subject to agreements permitting their financial institution to sweep their bank accounts may consider moving these funds prior to initiating creditor protection proceedings. Unfortunately this may create logistical challenges for a debtor company that must update any pre-authorized debit and payment arrangements during an undoubtedly already turbulent time.

Conversely, financial institutions may elect to sweep early and sweep often. While the cost award was intended to penalize HSBC for its actions and perhaps act as a disincentive to other lenders considering pursuing similar behaviour in the face of a stay of proceedings, the $50,000 award is nominal compared to the dollar-for-dollar recovery HSBC achieved on the $6.8 million owed to it. Will *Carillion* ultimately incentivize lenders to sweep early and beg for forgiveness later? Will the courts be as forgiving in the future? Every case will need to be considered according to its unique factual circumstances.

This article is intended for informational purposes only and does not constitute legal advice or an opinion on any issue. For additional details or advice about specific situations please contact our insolvency and restructuring group.

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