NORTON ROSE FULBRIGHT

Legal update

Approval of third-party releases under the CCAA: the court lowers the bar in *Aquadis*

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Bankruptcy, financial restructuring and insolvency

A monitor appointed under the *Companies' Creditors Arrangement Act* (CCAA) may commence a claim against third parties in the name of the debtor. The purpose of such a claim is obviously to maximize the value of the debtor's assets for the benefit of its creditors.

In the event the monitor settles a claim with some of the defendants, the latter will usually insist on obtaining a full and complete court-approved release. Courts will generally approve the release if it is fair and reasonable in the circumstances and if the rights (both procedural and substantive) of the non-settling defendants are protected.

In a recent decision, the bar for approving a third-party release was, however, significantly lowered. In the matter of *Aquadis,*[1] the court indeed approved a settlement agreement (i) granting release to defendants who did not contribute to the settlement, (ii) offering no procedural protection to the non-settling parties, and (iii) offering very limited protection to the substantive rights of the non-settling parties.

The factual context

The debtor 9323-7055 Québec inc. (formerly Aquadis International Inc.) was a wholesale seller of plumbing fixtures. It, however, suffered serious financial difficulties when hundreds of defective faucets supplied by it failed, causing significant damage to property owners whose insurers ultimately filed subrogated claims against Aquadis. The value of those claims amounted to nearly $22 million and the monitor estimated the value of potential future claims at an additional $25 million.

To maximize the value of Aquadis' assets, the monitor commenced proceedings against the manufacturer and the distributor of the faucets and their respective insurers. The court also allowed the monitor to commence proceedings against the retailers who had sold the faucets to the consumers, not in the name of the insolvent debtor (which had no right of action against the retailers), but in the name of the debtor's creditors (i.e., the property insurers that had filed subrogated claims against Aquadis).

The monitor subsequently received offers of settlement from the manufacturer and the distributor's insurers, and the monitor sought court approval of the offers. Such approval was, however, opposed by the retailers on the grounds the manufacturer and the distributor were released although they were not contributing financially to the settlement.

The retailers also argued the terms of the offers infringed their rights to commence a claim in contribution against the manufacturer and the distributor. To defeat that argument, the offers were amended to add a comfort clause providing that the retailers' potential liability was to be reduced by any sum the retailers were able to demonstrate as recoverable from the manufacturer or the distributor had the settlement not been entered into.

The decision

The court rejected the retailers' arguments and approved the settlement offers, noting the offers were the result of a fair process and in the best interest of the creditors. The fact the manufacturer and the distributor were being granted releases although they did not financially contribute to the settlement (only their insurers contributed to the settlements) was not considered sufficiently important to deprive the creditors of the benefit of the settlement amounts.

While not perfect, the court also held that the comfort clause was valid in the circumstances since it was consistent with article 1531 of the *Civil Code of Quebec* (CCQ)[2] and with similar provisions in *Pierringer*-type agreements. The court reached that conclusion despite the fact that applying the comfort clause was highly problematic for potential future claims (which were estimated at $25 million by the monitor) and that, contrary to the situation usually prevailing in *Pierringer*-type agreements, the liability between the various defendants was not joint and severable in the circumstances. The fact the settlement offers were not providing for any protection to the retailers' procedural rights was not even considered by the court.

Take-away

The decision in *Aquadis* shows courts may sometimes be willing to lower the bar regarding the conditions for approval of settlement offers providing for third-party releases. It seems that to the extent a court finds the settlement offer is beneficial to the creditors and to the restructuring or liquidation of the debtor, the criteria that have been reiterated by the leading case law may be applied with more flexibility and to the detriment of the substantive rights of third parties.

The impact of *Aquadis* is, however, difficult to predict. Although leave to appeal of the first instance judgment was dismissed by the Court of Appeal because the settlements had been executed by the time it heard the case, the Court of Appeal felt the need to add that "[…] the effect of global releases arising from partial (as opposed to global) settlements has not been entertained by this Court and the jurisprudence in the rest of Canada is not, arguably a closed book." It will thus be interesting to see whether Canadian courts will follow the steps of the decision rendered in *Aquadis* or whether they will adhere to the more stringent conditions developed by previous case law.

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Footnotes

1 Arrangement relatif à 9323-7055 Québec inc. (Aquadis International Inc.), 2018 QCCS 2945, leave to appeal to the CA refused (August 15, 2018), Montreal 500-09-027630-185 [Aquadis].

2 Article 1531 CCQ provides: "[w]here, through the act or omission of the creditor, a solidary debtor is deprived of a security or of a right which he could have set up by subrogation, he is released to the extent of the value of the security or right of which he is deprived."

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