

Canadian corporate bankruptcy: law and public policy

A contribution to the program

Bankruptcy in Russia: formation of the institution of bankruptcy and its regional specifics

of the
Institute for the Economy in Transition
Moscow

Harry Swain
Trimbelle Limited
Toronto
August 2003

Canadian corporate bankruptcy: law and public policy¹

Harry Swain
Trimbelle Limited
July 2003

As in so many other areas of its national existence, Canada's bankruptcy law and practices stem from a joint Anglo-French heritage.² From the United Kingdom comes the backbone of a creditor-friendly bankruptcy law, so different from the relatively populist and debtor-friendly *Bankruptcy Code* of the United States.³ It is leavened with a sprinkling of imports from the Napoleonic *Code civile*, still the source of commercial law in Quebec.

The intent of this paper, a contribution to studies by the Institute for the Economy in Transition of Moscow preparatory to further amendments to Russian corporate bankruptcy law, is to outline certain features of the operation of Canadian bankruptcy law, both in general and in light of specific problems facing Russian reformers. The paper opens with some observations on the characteristics of a good ("optimal" is too strong a word) bankruptcy system and moves on to a summary description of how the Canadian system works. This is followed by a brief section on how the system has changed in recent years and on the topics that will likely feature on an agenda for further reform in the next Parliament. The paper concludes with a summary response to questions raised by Russian colleagues. It

¹ I thank the following individuals, who have variously contributed advice, documents, memories and warnings in the preparation of this report. From Aird & Berlis, Lawrence J. Crozier and Stephanie Fraser; from Industry Canada, Jacques Hains, Gilles Gauthier, Jim Buchanan and Andrei Sulzenko; from Sussex Circle, Jim Mitchell; from the Council of Ontario Universities, Ian Clark. The author remains solely responsible for errors and omissions.

² "Parents unmarried and living abroad..." Earle Birney, "Canada: a case history," in F.R. Scott and A.J.M. Smith, *The blasted pine*, Toronto, Macmillan, 1957

³ The Americans spent more than a century, from 1793 to 1898, trying to define a stable bankruptcy regime. The financial houses of the northeast wanted solid creditor protection, while the agrarian south, oriented toward states' rights, tended to be sympathetic to debtors, especially farmers, and wanted no federal law. Several laws were passed and then repealed during the course of the 19th century. It was not until the reorganization of failing railroads became a matter of urgency in the aftermath of the Civil War that a stable regime was finally established under federal jurisdiction, and even then it took until 1898. D.A. Skeel, Jr., *Debt's dominion: a history of bankruptcy law in America*, Princeton University Press, 2001.

is intended that this paper will be revised and extended in 2004 to respond to specific interests of IET researchers.

Background: economics of bankruptcy

Bankruptcy procedures are often stated as having the equitable administration of the remaining assets of a bankrupt person or corporation as their fundamental purpose. In the words of a leading Canadian authority,⁴ “bankruptcy legislation is designed:

1. *to distribute the proceeds of the bankrupt’s assets equitably* and in accordance with a scheme of distribution.
2. *to punish fraudulent debtors* where there are breaches of certain standards of conduct...
3. *to reform debtors* whereby individual bankrupts can relieve themselves from financial obligations and become rehabilitated.
4. *to promote confidence in the credit system* such that credit grantors can believe that the system operates fairly with a means of seeking redress for wrongdoing and treating all persons of a like class in the same manner.”

Many of the commentators on bankruptcy tend to come from a legal background. It is thus unsurprising to see an emphasis on fair and equitable procedures and the punishment of wrongdoers in their writing. From the point of view of economic policy, however, there are really two classes of objective – equity and efficiency – with the latter, perhaps because of its analytic interest, usually taking precedence among economic commentators. The first three objectives above address equity, while the fourth deals squarely with one of the principal issues of economic efficiency. In reality, of course, all involve efficiency through the provision of a structure in which the consequences of financial failure can be administered in a manner more orderly and less wasteful of economic resources than, for example, self-help or debtor’s prisons.

⁴ F. Bennett, *Bennett on creditors’ and debtors’ rights and remedies*, 4th ed., Carswell, Toronto, 1994, 534

From the viewpoint of economic efficiency, two broad objectives should inform policy. One, as Bennett notes, is creating and maintaining faith on the part of creditors that they will be dealt with fairly and swiftly in the case of the ultimate test of the debtor. Only if there is a widespread belief, supported by everyday administrative experience in hundreds of cases, in the predictability, speed and certainty of bankruptcy procedures can both transaction costs and the costs of debt capital itself be minimized. Keeping such costs low is of the essence when it comes to investment and economic development. What happens in the desperate world of bankruptcy affects all companies by affecting the cost and availability of capital.

The second economic efficiency objective has to do with the bankrupt estate itself, and is especially relevant to the case of corporate bankruptcy. There is a social interest in transferring the assets of the failed owners and managers into new hands as swiftly as possible so as to forestall the economic losses attendant on prolonged inaction. A company in bankruptcy will find it difficult to obtain new orders, acquire supplies and credit, and attract and retain energetic, talented workers and managers. A business that is fundamentally sound – capable of profitably producing goods or services if unburdened of past errors – is itself an important piece of social capital. If its structure of customers, suppliers, employment and tax contribution is destroyed, it may well be that all its individual production resources will in time find other employment in the economy, but only after large transaction costs, including the loss of the value of the firm as a going concern. Externalities include such losses not provable as claims in bankruptcy as those suffered by suppliers and their workers, a lessening of investment by those firms, customer costs incurred in searching for new suppliers, and the contribution to local charities and community life offered by the lost firm. In Canada, any tax loss carry-forwards disappear on the dissolution of the firm, when its assets are sold off piecemeal, which is one reason that acquisition is a frequent means of ending financial distress. There is thus a broad interest in maintaining the entity, so long as its going-concern value exceeds its liquidation value. This usually means restructuring or reorganizing the business to deal with the consequences of past errors by management or owners.

In practice, this efficiency objective is best approached by putting energetic new owners and managers who have concrete ideas about how to rejuvenate the business in charge – swiftly,

and at a price which assigns the consequences of past errors to those who made them. Those who get to “take a haircut,” as the Street slang has it, include owners of common stock, owners of preferred stock, unsecured creditors, secured creditors, and the Crown, in that order. The new owners – typically creditors who have exchanged their debt for equity – will appoint new directors, and the directors in turn can be expected to appraise with a cool eye the managers who brought the firm to its knees. Many will be replaced.

The fundamental operational question during a corporate bankruptcy therefore rests on a judgment about whether economic value is best preserved by keeping the business going, albeit with a price to be paid in terms of restructuring, or whether to break it up and let its individual assets dissipate, eventually finding new employment elsewhere in the economy. This judgment usually has to be made under stressful and hurried conditions, and is constrained by the equitable rights of the many parties to a bankruptcy. And the bigger the corporate failure, the more complex are the claims. One test of bankruptcy law is thus whether or not such judgments can be made and carried out coolly and objectively under conditions of great stress.

The way in which this crucial judgment is made depends on the mechanics of the judicial and administrative systems under which it takes place. Creditor-friendly regimes, like that of the UK or Canada before 1992, generally put the assets of the failing firm in the hands of a trustee who quickly liquidates them, possibly in a single sale, for the benefit of the creditors. Management, directors and shareholders bear an immediate price. In such regimes there is a tendency for bankruptcy filing to occur rather later than economically optimal, as an increasingly desperate management with nothing to lose hazards ever-larger bets with other peoples’ money. At the other end of the spectrum, the US Chapter 11 procedure may be making it too simple for managements to use bankruptcy as an ordinary piece of business strategy. Delaney cites the cases of Manville, Continental Airlines and Texaco as examples.⁵ Further, judges operating under the US Chapter 11 procedure may be insufficiently expert. Baird and Morrison argue:⁶

⁵ K.J. Delaney, *Strategic bankruptcy: how corporations and creditors use Chapter 11 to their advantage*, Berkeley, University of California Press, 1998

⁶ D.R. Baird and E.R. Morison, “Bankruptcy decision making,” *J. Law, Econ. & Org.*, 17:2 (2001): 366-7

Bankruptcy judges are imperfect substitutes for market actors. Market actors have their own money on the line and this makes them intensely interested in making good decisions. Moreover, there is a natural sorting mechanism, as only those market actors who make good decisions survive. There is no similar competitive process or sorting mechanism for bankruptcy judges. They are subject to reappointment only every 14 years and making the shutdown decision is a small part of their docket. Moreover, the people who make the reappointment decision (other federal judges) are not themselves well positioned to assess the bankruptcy judge's performance.

In addition, once the Chapter 11 case starts, the judge must stand at a distance. Section 341 of the [US] Bankruptcy Code forbids the bankruptcy judge from attending the meetings at which managers of the firm must turn over information to the creditors. Rules of judicial conduct limit the ability of the bankruptcy judge to gather information informally. She cannot even talk to any of the players outside the presence of the others, nor can she conduct her own investigations.

These comments could apply equally to Canadian judges, most of whom (outside of Toronto) hear bankruptcy cases with no special expertise.

A key point is that making the delicate decision whether to reorganize or liquidate depends on the fullest disclosure of relevant information, as well as experience and sagacity. Systems which force the early production of a great deal of information to all parties will tend to have better outcomes, in the sense that bargaining strategies in those circumstances are more likely to drive toward solutions where all parties are better off than they would be in situations of strong information asymmetry.⁷

Equity is the other great economic objective. Although its impulse is social, stemming from innate feelings about fairness and natural justice, especially for parties less able to protect themselves through access to information or through good contracts, it too has a relation to economic efficiency. Only if claimants are dealt with fairly and reasonably swiftly can the risks and costs of extending credit be minimized. Prof. Davis, in a thoughtful but unpublished paper prepared for Industry Canada as part of its preparation for the next round of legislative amendments, notes that there are a number of possible definitions of both equity and efficiency, but that in practice they are mutually supportive.⁸

⁷ K.E. Spier, "Settlement with multiple plaintiffs: the role of insolvency," *J. Law, Econ. & Org.*, 18:2(2002): 295

⁸ K. Davis, "An economic analysis of the differences between Canadian and American commercial insolvency laws," Industry Canada, March 2002, 66pp.

Davis goes on to note that an optimal bankruptcy system must take account of the size and industrial structure of the economy to which it applies. A country dominated by small enterprises in large places whose individual disappearance will cause few external costs may be best served by a swift, rules-based system, whereas a country with a relative handful of large enterprises in small towns may need the flexibility to tailor solutions to specific cases. Canada has both, which leads Davis to suggest that the co-existence of a rules-based system together with one based on more general standards may suit its requirements better than the uniform *Bankruptcy Code* of the United States.⁹ In addition, there is ambiguity about whether a specialized bankruptcy court is better than having such cases heard by judges having broad responsibilities.¹⁰

The Canadian system

Canada is a confederation of the British North American colonies left over after the revolutionary departure of the United States. Most were “colonies by settlement,” meaning that, in general, all English law then in force and applicable to the circumstances of the particular colony were continued in colonial practice. Newfoundland, despite subsequent transfers between English and French sovereignty, was in 1583 the original British colony by settlement. One colony, Quebec, became English by conquest in 1759. In such cases the imposition of English law over the pre-existing regime, while still generally favoured, was strongly affected by the nature of the new territory. In the case of Quebec, with its French law and language and its strongly Catholic religious base, caution and magnanimity both led to the *Quebec Act* of 1774 in which many of the legal traditions of the French regime were continued. This English statute is now part of the constitution of Canada.

Four colonies (Upper and Lower Canada, corresponding to Ontario and Quebec today, plus New Brunswick and Nova Scotia) were united as Canada by the *British North America Act* of 1867, an act now referred to as the *Constitution Act, 1867*. Rupert’s Land, essentially the

⁹ Cf. L. Kaplow, “Rules versus standards: an economic analysis,” *Duke Law J.*, 42(1992): 557; P. Povel, “Optimal ‘soft’ or ‘tough’ bankruptcy procedures,” *J. Law, Econ. & Org.* 15:3(1999): 659-684

¹⁰ Davis, *op. cit.*, pp. 21-26

present Prairie provinces, the Arctic and the Hudson Bay lowlands, was included as the North West Territories in 1870, with the new province of Manitoba carved out. Prince Edward Island and British Columbia joined in 1871, and the present map was completed with the admission of Newfoundland in 1949.

Early statutes dealt with debt, seizure, insolvency, and the relief of debtors in the several colonies before Confederation.¹¹ Typically based on English statutes going back to the Renaissance, they applied only to “traders” and required the surrender of a debtor’s property to a court-appointed official (“curator”), who would distribute the bankrupt estate among the creditors. Many types of debt survived bankruptcy, however, and no provision was typically made for the bankruptcy of individuals – farmers, for example – or types of firms other than traders. In many respects the inheritance from the Napoleonic *Code civile* was superior, especially in that it included detailed procedures for the administration of the bankrupt estate. Concepts from that legal tradition entered British and later Canadian law through the “monumental work of revision and codification”¹² of Quebec law following 1857.

The first attempt at a post-Confederation statute was *The Insolvent Act* of 1875, which repealed the mass of pre-existing colonial laws and applied a uniform structure to all the provinces. Coverage was broadened somewhat from traders and trading partnerships, and voluntary assignments were dropped in favour of creditor-initiated processes when a debtor generally failed to meet his liabilities as they became due. “Creditors, however, had the alternative remedy of applying to the Court for a writ of attachment under which the property of the debtor was seized.”¹³ However, although it was amended in 1876 and 1877, the Act was repealed in 1880 and for forty years there was no general bankruptcy law in force in Canada. “There was dissatisfaction with the method of administration [a strength of the *Code civile*], and the constant irritation caused by ill-considered legislative tinkering with so important a piece of legislation brought to a head the movement for the repeal of the Act.”¹⁴

¹¹ L. Duncan and J.D. Honsberger, *Bankruptcy in Canada*, 3rd ed., Canadian Legal Authors, Toronto, 1961, ch. 2, pp. 5-14

¹² *Ibid.*, 10

¹³ *Ibid.*, 16

¹⁴ *Ibid.*, 17

Three statutes presently govern bankruptcy in Canada. All are federal statutes, since Section 91(21) of the *Constitution Act, 1867* assigned the subject to the federal level of government.¹⁵ The basic statute, used for both commercial and personal bankruptcies, is the *Bankruptcy and Insolvency Act* (BIA), first enacted in 1919 and amended in 1949, 1992 and 1997.¹⁶ Based on the 1904 United Kingdom statute, the 1919 *Bankruptcy Act* focused (until the amendments of 1992) on liquidation rather than reorganization. In 1992, Part III was broadened to expand the powers of debtor companies to effect proposals and supervised reorganizations.

A second statute, the *Companies' Creditors Arrangement Act* (CCAA), was enacted in 1933 in response to the grim economic conditions of the Depression.¹⁷ A brief, reorganization-oriented statute, it gave judges latitude to make broad compromises, suiting outcomes to the peculiar circumstances of the time. It was not much used until the 1980s, when enterprising lawyers discovered it could be useful in the complex situation of large corporate bankruptcies. It was amended in 1997 to make it more consistent with the BIA.

The final statute in the trio, the *Winding-up and Restructuring Act* (WUA),¹⁸ applies primarily to insolvent banks and insurance companies; unlike the other laws, which fall to the

¹⁵ Section 92(13), however, assigns to the provinces the exclusive right to make laws in relation to “property and civil rights.” As in other areas where this sometimes vague 19th-century statute of Westminster creates potential conflicts between the two levels of government, the courts resolve the conflicts by considering the “pith and substance” of the legislation. “If the primary object or pith and substance ... falls within one of the enumerated subjects of section 91, it will be considered to be within the federal power notwithstanding that it may incidentally affect a subject matter which has been assigned to the provinces. Therefore, while the powers of the federal government in respect of bankruptcy and insolvency include the power to enact ancillary legislation to give effect to its legislation on bankruptcy and insolvency, these matters are limited to those matters which, in pith and substance, fall within the definition of bankruptcy and insolvency.” Sean F. Dunphy, “Bankruptcy and insolvency, reorganization and winding-up,” chapter 12 in M.E. Grottenthaler, ed., *Doing business in Canada*, Stikeman Elliott, Montreal, 1997. In addition, the BIA provides that the decisions of one provincial court are enforceable by any other, and all are required to act in aid of each other. In these ways, through the slow piling up of case law and through administrative cooperation, conflicts between the specific federal jurisdiction over bankruptcy and the much broader provincial responsibility for property and civil rights are managed with remarkably little friction.

¹⁶ There had been *Insolvency Acts* in 1869 and 1875, but these were repealed in 1880. The current (1997) Act is reproduced with substantial annotations in two well-known books: F. Bennett, *Bennett on Bankruptcy*, CCH, Toronto, 7th ed., 2002, and L.W. Houlden and G.B. Morawetz, *The 2003 annotated Bankruptcy and Insolvency Act*, Carswell, Toronto, 2002 (annual). The bare text of the Act may be found (July 2003) at <http://laws.justice.gc.ca/en/B-3/text.html>.

¹⁷ Both Bennett and Houlden & Morawetz (note 11) include annotated texts of the CCAA. The bare text is available on <http://laws.justice.gc.ca/en/C-36/text.html>.

¹⁸ Text available at <http://laws.justice.gc.ca/en/W-11/text.html>.

responsibility of the Minister of Industry, WUA is jointly administered by the Ministers of Finance and Industry. It is rarely used.¹⁹ In addition it is possible conjointly to use the corporate organization statutes of either the federal (*Canada Business Corporations Act*, or CBCA) or provincial governments (such as the *Ontario Business Corporations Act*) to effect a restructuring of share capital where the company is insolvent.

The Bankruptcy and Insolvency Act

The BIA is the basic statute. Its scheme is that, following an act of bankruptcy, the assets of an insolvent corporation are transferred to a trustee, who liquidates them for the benefit of the creditors. A company may be reorganized or sold as a going concern, with its basic contractual structure intact, or its assets may be sold in pieces. Creditors are paid according to a set order of priorities.

Under the BIA a company can go bankrupt on its own motion, or its creditors may petition the court to have it declared bankrupt. In the first case an insolvent debtor company may make an assignment of all its property to an Official Receiver or may make a proposal to its creditors for a restructuring of debt. Creditors also have the right to petition the court for a receiving order which, assuming the debt involved exceeds \$1,000 and the debtor has committed one or more acts of bankruptcy, will normally be granted, putting the debtor company into bankruptcy. In either case the Official Receiver, who is an officer of the court, chairs the first meeting of the creditors. In the case of a proposal, the debtor engages a trustee to perform the day-to-day administration of the bankrupt estate; in the case of an assignment, the creditors select the trustee. In the latter case, the trustee thereafter has complete control and administration of the assets, subject to oversight from the court, the Superintendent, and the inspector(s) appointed by the creditors at their first meeting. The directors and the management of the insolvent firm have no discretion and may in fact be unemployed, although with the approval of the inspectors, some or all of the former managers may be retained to assist with the administration of the firm or other proceedings in bankruptcy.

¹⁹ But when it is, the cases tend to be spectacular, as in the case of the failure of Confederation Life in 1994: R. McQueen, *Who killed Confederation Life?* Toronto, McClelland & Stewart, 1996

In the case of a proposal, the debtor remains in control of its assets under the supervision of a trustee. Ultimately, the debtor must within six months obtain creditor and court approval of its proposal.

Since the first step into bankruptcy entrains such serious consequences, it is not taken lightly; nor is it easy for a creditor to act on some technical breach to throw out management and seize the assets. The court must be satisfied, on evidence and with the ability of the impugned debtor to contest the petition, that one or more of the ten acts of bankruptcy enumerated in section 42 of the BIA (see Annex A) have occurred within the six months preceding the filing of the petition. The judge, the Registrar of the court, the Official Receiver and the Superintendent all remain seized of the issue until final disposition.

Trustees

The key player is the trustee. Private professionals licensed and regulated by the federal government through the Superintendent of Bankruptcy, trustees are usually chartered accountants; in any case they must pass rigorous examinations and keep up to date with changes in law and practice. They must avoid conflicts of interest and abide by ethical rules established by the Superintendent. As the powers of the trustee (Annex B) are considerable and must usually be exercised under emergency conditions, high standards of training, experience, supervision and public reporting are important. The inspectors appointed by the creditors function as a special kind of board of directors and many of the actions of the trustee are subject to their approval. The court remains available to resolve disputes.

The trustee is responsible for making a list of all creditors, taking control of the business and all its books and assets, deciding (with the approval of the inspectors) whether liquidation or sale as a going concern will yield best value, realizing that value, and paying the proceeds, less his fees, to the creditors according to the rights of precedence established in the Act. The procedures to be followed, right down to the forms to be used, are specified in considerable detail in the Act and elaborated in the Superintendent's Directives, which like regulations have the force of subordinate law. The trustee's multiple roles – administrator, creditors'

agent, advisor and counselor to debtor – can cause conflict and must be managed scrupulously.²⁰

The Superintendent of Bankruptcy

This official is a federal civil servant. A senior officer in the Industry department, he or she is subordinated to the Minister and Deputy Minister only in regard to resources and routine administrative matters and not in respect of the substantive matters of his office. This arm's-length relation with the political system is shared with other officials of that Department who are named in statute, such as the Commissioner of Competition, the Commissioner of Patents, and the Director under the CBCA. The Superintendent's colleagues and superiors are not entitled to know information about bankrupts that is not part of the public record and a breach of that confidentiality would subject the Superintendent to disciplinary action up to and including dismissal. Only in cases where the Superintendent's actions are impugned does the Minister become involved, and then by convention only through a distinguished proxy.²¹

The Superintendent oversees the administration of all estates and matters to which the BIA applies. He does this by establishing standards for the licensing of trustees and by licensing them following examination, by requiring bonds from them as surety for the faithful fulfillment of their duties, by publishing Directives (including a code of ethical conduct) and information memoranda for the guidance of trustees, by intervening in court or administrative matters on his own motion, and by keeping and publishing records. Matters of record include complaints against trustees, proposals, bankruptcies, licenses, and notices sent to receivers. Since 1992 he has had a limited mandate to keep records regarding reorganizations under CCAA, but this is a relatively undeveloped area. The costs of the Superintendent's office are partly recovered by a levy on trustees' distributions to creditors.

²⁰ I. Ramsay, "Market imperatives, professional discretion and the role of intermediaries in personal bankruptcy: a comparative study of the Canadian trustee in bankruptcy," *Am. Bankr. Law J.*, 74:4(2000): 399-460. Ramsay's study focuses on personal bankruptcy, where arguably the possibility of conflict is more acute.

²¹ In a 1993 case, for example, a trustee was found by the Superintendent to have falsified records and stolen money from a bankrupt's assets. The trustee was dismissed and his license to practice revoked. Following his suicide, the widow claimed compensation for lost income. In such cases the appeal lies directly with the minister, who invariably appoints, on advice, a senior administrative law judge, usually retired, to hear the appeal and make a decision on his behalf.

Receivers

In the Canadian law of secured transactions, the major remedy given to secured creditors is to provide that on default, a receiver may be appointed to immediately take possession of the collateral and either operate or liquidate the business for the benefit of the security holder. This technique is known in Canada as a “receivership.” Such situations may be unrelated to bankruptcy, may precede it, or may become an incident in it. Receivers are private professionals hired by the creditor to realize on security. They are almost always but not necessarily qualified as trustees in bankruptcy.

The Companies' Creditors Arrangements Act

Unlike the BIA with its carefully choreographed, time-limited steps, CCAA is quite open-ended. Action under the CCAA commences with a court application by the debtor company, and relief is in the discretion of the judge. Thereafter, control of the proceedings is entirely in the hands of the judge. The Act provides relatively little in terms of procedural guidance, with the result that judges have wide latitude to fashion procedures, actions and remedies that fit the case in hand. This flexibility is generally believed by the business community and its professional advisors to be useful, especially in the case of large and complex bankruptcies. Since 1997, access to procedures under the Act has been limited to insolvencies where the assets involved exceed \$5 million.

Canada does not have a specialized bankruptcy court, but it does have some judges who have become expert in these proceedings. In Ontario, under the leadership of Mr. Justice James Farley, a subset of provincial court judges known as the Commercial List have come to handle most CCAA cases.²² There is a debate in the literature about how much a judge can be expected to know of the affairs of a given company in a complicated industry and

²² Farley J. is in charge of the current headline-making case of Air Canada. His style is to move rapidly, setting aggressive deadlines for parties to settle specific issues and report them to the court for approval. In this way the expert and involved parties hammer out the details, relieving the bench of all but procedural and final decision-making. Recently lawyers for contending groups of Air Canada pilots were startled to be ordered to complete their negotiation by midnight on a Saturday and report the results in court on Sunday morning.

whether a specialized court is a good thing or not.²³ Under the BIA the trustee is advised by a creditors' committee made up of creditors' representatives known as inspectors. The trustee may engage members of the former management for day-to-day administration, thus easing the expertise problem. Under CCAA, a wise judge makes the parties do most of the substantive work while requiring the debtor through a court-appointed monitor to provide the court and all other parties with the voluminous information that alone can lead to wise choices. This aggressive involvement of the bench in requiring the production of information, even to the extent of intervening on its own behalf, is one striking difference from the US Chapter 11 process, where the judge must be at pains to keep a distance from the proceedings and the players and act only on the motion of one of the parties.²⁴

Reorganization proposals

A company in or approaching insolvency may opt for reorganization rather than liquidation. It may proceed either under Part III of the BIA or, if liabilities exceed \$5 million, under CCAA. In either case, the distressed company makes a proposal to its creditors, who then decide whether or not to support it. A stay of proceedings by unsecured debtors normally follows while the restructuring takes place. At the end of the process it is expected that the company will continue under different ownership, and probably different management. The processes differ in detail, however.

(i) BIA proposals

Under the BIA, reorganization starts with a filing in provincial court by an insolvent company of either a proposed compromise or rearrangement of creditors' claims, or, since fully fledged "pre-packaged" proposals occur only in simple cases, a notice of intention to file such a proposal. The notice of intention includes the name of the trustee who has agreed to serve and the names of all creditors owed more than \$250 and the amounts owed. Copies of the filing must be delivered to all known creditors within 5 days, followed within 10 days

²³ Davis, *op. cit.* 21. An interesting comparison of Canadian versus Chapter 11 procedures suggests that Canadian reorganizations are swifter, cheaper, and more likely to be consummated: T.C.G. Fisher and J. Martel, "Should we abolish Chapter 11? Evidence from Canada," *J. Legal Stud.*, 28(1999): 233-257

²⁴ D.G. Baird and E.R. Morrison, "Bankruptcy decision making," *J. Law, Econ & Org.*, 17:2(2001): 356-72; see also Davis, *op. cit.*

of the original filing of a cash flow statement attested to by the trustee. There is an automatic stay of proceedings by all creditors including secured creditors for 30 days, although unsecured creditors can petition for abridgment on the grounds that no proposal could gain support.

The stay of legal proceedings is critical. Without it, uncoordinated “sauve qui peut” actions by creditors will consume all executive time, leaving no resources for managing the business or putting together a proposal or plan of arrangement. But such a large interference with the rights, obligations and expectations under normal contracts must be carefully hedged and time-constrained. Under the BIA a 30-day stay is automatic. Thereafter, if the court is satisfied that the debtor is working in good faith toward a viable proposal that will not materially prejudice the rights of secured lenders, three further stays of 45 days each may be granted. As the BIA has no super-priority for debtor-in-possession financing, the debtor must finance operations from cash flow, from pledges of unsecured assets, or by using secured assets. Under the circumstances the courts will interpret “material prejudice” to secured interests with a degree of liberality. However, “a secured creditor whose collateral is being consumed without being replaced will be well-positioned to demand an end to the stay of proceedings.”²⁵

Once a proposal is filed, the trustee calls a meeting of creditors within 21 days, during which the stay remains in place. Each class of creditor votes separately, and it takes two-thirds in value and half in number of the creditors in a class for the proposal to bind that class. The court is asked to approve the proposal but will refuse to do so if the terms are unreasonable, if the debtor has committed specific offences enumerated in Sections 198-200 of the Act (bankruptcy offences, failure to disclose the fact of being undischarged, failing to keep proper books of account), or if no super-priority has been provided for Crown claims, certain wage and landlord lease payments, and trustee fees. If the proposal is rejected by the creditors, or if there has been any fraud or default by the debtor, the proposal fails and the debtor is deemed to have made an assignment in bankruptcy. Liquidation follows.

²⁵ Dunphy, *op. cit.*, §12.04[3]

A successful proposal must be fully performed. Once that happens, the trustee so certifies to the debtor and the Official Receiver and an application for discharge follows. Assuming good behaviour of the bankrupt during the period of the reorganization, the court will grant discharge.

“A basic difference between a proposal under the BIA and a Chapter 11 reorganization under the US *Bankruptcy Code* is that in Canada, there must be a trustee who, as an officer of the court, is responsible for administering the proposal. There is no provision under the BIA for a debtor in possession administering its own proposal as there is in the United States.”²⁶

(ii) CCAA Plan of Arrangement

CCAA is more flexible. The grant, scope and timing of any stay are in the discretion of the judge, though case law is firming up. While the scope of the stay may be broader than under the BIA, the judge must be satisfied that the stay is in the best interests of both debtor and creditors. Under CCAA all classes of creditors must approve the plan of arrangement. Since 1997, the same two-thirds of value and half in number of creditors as in the BIA must approve. Since the greater the number of classes, the greater the probability of a refusal by one class, and since Canadian law does not include the US concept of “cram down” under Chapter 11, the definition of classes becomes a matter of some art. The definitions are proposed by the debtor, may be opposed by creditors, and must be approved by the judge.

Under CCAA, the judge remains an active player throughout the entire proceeding. He is entitled to all information about the plan of arrangement and actions taken by any party under it. He must, under the statute, appoint a monitor (who may or not be the debtor’s auditor) as an officer of the court to oversee financial reporting and the debtor’s actions generally. He may make such procedural or substantive orders as he judges likely to lead to the attainment of the reorganization objective of the Act, and he may do so on his own account or on the motion of any of the parties.

²⁶ L.J. Crozier, personal communication

“The CCAA has gained popularity as an instrument for the reorganization of insolvent debtors because it is a less technical and more flexible statute than the BIA. In addition, unlike the BIA, it has the advantage that the failure of a plan to obtain creditor approval does not result in automatic bankruptcy. However, as all proceedings under the CCAA are directed by the Court they are generally more costly than a reorganization under the BIA. Thus, the CCAA tends to be used only in very large retailing and manufacturing reorganizations. Most reorganizations in Canada occur under Part III of the BIA.”²⁷

Legislative reform of the Canadian Acts

The BIA and CCAA are important pieces of marketplace framework legislation whose provisions affect thousands of companies directly and many more indirectly. They have important effects on the cost and availability of capital throughout the whole economy. Their provisions need periodic updating to take account of changing technology, commercial practices and social norms. It may be thought surprising, therefore, that the 1919 BIA has been amended only three times – twice in the last decade – and CCAA only once, and then largely as a consequence of the 1997 BIA amendments.

Politics of reform

In fact there are several reasons for these long delays. At heart is the problem that there is never much of a consensus among the various stakeholders about what amendments should be made. Creditors and debtors are competitive players in a less-than-zero-sum game and fiercely defend or seek to extend their existing priorities. Arguments are often polarized by references to heartless bankers throwing innocent people out of work through a too-zealous concern about the rights of secured creditors, or by the wrenching claims of unpaid wage-earners, trade creditors, widows and orphans, and even farmers and fishermen. Weak parties with inadequate information or contractual rights to protect their own interests are protected to a degree by statute – often, it may be claimed, at the price of near-fatal compromises of

²⁷ L.J. Crozier, personal communication.

the commercial credit system. It does not help in these heated and political arguments that the external costs of bankruptcy, including higher interest costs generally, are borne by firms and individuals who may never otherwise contact the bankruptcy regime. Organized lobbies of interested parties may find it difficult to pass amendments to their liking, but they have less difficulty in blocking those favoured by others.

Under these circumstances there is little reward for politicians to risk their re-election on a subject where, it seems, any given proposal is opposed by three-quarters or more of the affected parties. Indeed, this was the legislative fate of comprehensive BIA amendment bills on several occasions between 1975 and 1984, following the Tassé Report of 1970.²⁸ Three events came together to allow the first amendments in 44 years to be passed in 1993. First, the US greatly modernized its procedures in its *Bankruptcy Code* of 1978. Here as in other areas the Canadian government realized that there is a market for good framework legislation, and that if Canada did not keep up with developments abroad it could become less attractive as a place for investment. Second, the professionals in the bankruptcy business – the lawyers, accountants and trustees – started through their professional organizations to put forward well-argued and expert views that were not especially tainted by pecuniary interest. The Insolvency Institute of Canada, the Canadian Insolvency Practitioners Association, and the Canadian Association of Insolvency and Restructuring Professionals in particular have all been helpful in keeping the matter in the public eye and in putting forward well-reasoned proposals.²⁹ Third, the Department (at first Consumer and Corporate Affairs and after 1993, Industry Canada) learned that excellent analysis and legislative drafting done in secret had a wonderfully unifying effect on all interested parties when the surprise result appeared for first reading in the House of Commons. Unfortunately it tended to unify all parties against the Government proposal.

²⁸ Canada, Department of Justice, *Report of the study committee on bankruptcy and insolvency legislation (Tassé Report)*, Ottawa, 1970

²⁹ Cf. A.F. Kent *et al*, "Report of the Joint Task Force on business insolvency law reform," Insolvency Institute of Canada and Canadian Association of Restructuring Professionals, March 2002. Some would even argue that there may be too much professional influence on legal draftsmanship: B.G. Carruthers and T.C. Halliday, "Professionals in systemic reform of bankruptcy laws: the 1978 U.S. *Bankruptcy Code* and the English *Insolvency Act 1986*," *Am. Bankr. Law J.* 74:1(2000): 35-75

A breakthrough came in 1986 when, on the basis of the Colter Report,³⁰ the government undertook wide consultations with a view to finding compromise and consensus on as many terms as possible. This process, called by the officials who led it as “putting the inmates in charge of the asylum,” produced a reasonable consensus on a number of issues but fell short of the stem-to-gudgeon rewrite that many had hoped for. This is inherent in policy processes based on compromise and consensus but has the advantages of avoiding egregious error and smoothing legislative passage.

The 1992 amendments were thus explicitly seen as the first phase of a modernization process that would extend over many years – in fact, indefinitely. Taking as example the *Bank Act*, which contains a clause requiring Parliamentary attention every ten years, officials inserted a re-opener clause in the 1992 amendments, a clause that survived in 1997 and which will assure Parliamentary attention to the Act again in 2004.

For the 1997 amendment package – phase two – an external Bankruptcy and Insolvency Advisory Committee of more than 100 individuals representing about 50 organized interests was created under the chairmanship of the deputy minister. All interested parties – lenders, lawyers, trustees, consumers, students, labour unions, academics – were invited to spend many hours of mostly voluntary time over a period of some two years to hammer out the specifics of amendments that could be recommended by all. Sub-committees did research and reached workable compromises in a large number of specialized areas. Since the field of possible amendments was wide there was opportunity for a particular interest group to yield something in one area for a compensating gain in another. The deputy minister promised that he would recommend all points of consensus to the Cabinet, with the high probability that these would pass into legislation since, as by definition non-controversial items, they would consume relatively little parliamentary resources. Conversely, there were likely to be a small number of vital topics on which no consensus was possible. In that case, the promise was that the department’s preference (not necessarily the Committee’s) would form the basis of recommendations, and the Committee members would not get a chance to wordsmith the

³⁰ Canada, Consumer and Corporate Affairs, *Proposed Bankruptcy Act amendments*, Report of the Advisory Committee on Bankruptcy and Insolvency, 2nd ed., Ottawa, 1986

language. This was a powerful spur to cooperation and expanded consensus and in the end greatly eased passage through the House and Senate.

Amendments of 1992 and 1997

The main focus of the 1992 amendments was to shift the emphasis from straightforward asset liquidation to reorganization. A new commercial reorganization scheme, Part III, was added to the BIA. Secondary amendments streamlined the administration of bankruptcy and gave some protection to unpaid suppliers. Within five years of passage, some 3,000 reorganizations involving 17,000 jobs were performed under the new legislation, and about half the reorganized firms were still active and independent.³¹

Many of the 1997 reforms focused on ways to give effect to changing social norms in personal bankruptcy. On the corporate side, there were a number of reforms:³²

- Landlords' claims arising out of disclaimed leases could be for actual damages or for an amount determined by a formula (100 percent of the rent due in the first year after disclaimer, plus 15 percent of rent due over the remaining term, to an overall maximum not exceeding three years' rent), at the choice of the debtor.
- A super-priority was established for the governmental costs of environmental clean-up. Provinces in particular had been concerned about "orphan sites."
- Trustees, however, were no longer personally liable for environmental damage unless caused by their gross negligence or willful misconduct. If issued a remedial order the insolvency practitioner can comply, contest the order, seek a stay to assess the economic consequences of compliance, or abandon the affected property.

³¹ By contrast, under the US Chapter 11 procedure, the success rate is about 8 percent.

³² Summarized from the Senate briefing book prepared for the use of departmental officials in 1996; thanks to Jim Buchanan and Jacques Hains for the use of this historical document.

- Disincentives to directors were removed in order to encourage them to stay on and make decisions necessary to salvage the insolvent business. Claims against directors could be compromised as part of a reorganization proposal, directors were provided with a due diligence defence against having paid a dividend while the corporation was insolvent, and a stay of proceedings on recourse against directors during reorganization proceedings was introduced.
- Domestic rules were clarified so as to increase cooperation and coordination in international insolvencies: courts could recognize foreign representatives, and could make facilitating or coordinating orders, including stays in Canada. BIA rules continue to protect Canadian creditors and assets, however.
- CCAA was amended to import some BIA rules³³ for consistency and predictability while maintaining the flexibility to handle complex reorganizations. A threshold of \$5 million in liabilities was introduced. Financial disclosure by the debtor was greatly improved. A new officer of the court, a monitor (who might be the debtor's auditor) could be appointed to examine the debtor's affairs and file reports with the court. An initial stay of up to 30 days, without automatic extension, was introduced, but certain financial contracts, letters of credit and guarantees were exempted from the stay.
- New provisions were added regarding securities firms. Regulatory bodies can now initiate petitions, and a special new act of bankruptcy was introduced: a suspension for failure to meet capital adequacy standards. Trustees may deal with securities accounts without waiting for permission from an inspector. Street name securities were vested in the trustee, pooled, and allocated to customers in proportion to their net equity claims.

³³ For example, as in the BIA, creditors and suppliers are no longer obliged to extend further credit or supplies; with respect to Crown claims, stays, priorities and distribution rights were made to mirror the BIA; use of only one statute was made mandatory; voting in creditor classes was made consistent at two-thirds; various standard BIA forms were imported; and the CCAA provisions relating to international insolvencies, environmental liabilities, and directors' liabilities were made consistent with the BIA.

- In addition a variety of technical amendments were introduced to improve administration.

The agenda for further reform

Parliament will commence its 2004 review of the BIA, CCAA and related Acts with hearings before a Senate committee. In preparation, Industry Canada has commissioned and published considerable research that has been boiled down into a summary report.³⁴ Really a briefing book, the report isolates issues that may be ripe for reform and discusses options for their resolution without giving particular recommendations. Issues are grouped, however, in terms of the expected degree of consensus or controversy they will arouse.

The most controversial issues are thought to be the following:

- Wage-earner protection: the degree to which wage and pension income is protected. No consensus: this is the nexus of the classic less-than-zero-sum game.
- Unpaid pension contributions: whether the existing protection for unpaid contributions and unfunded liabilities of pension plans is adequate. Same comment.
- Debtor-in-possession financing. There is agreement that in Pareto-efficient cases where secured debt would not be materially compromised new debt should be allowed to take precedent over old. The BIA does not contemplate this while CCAA seems to allow judges to do anything at all that they find to be in their “inherent jurisdiction.” There is some envy about the rules on debtor-in-possession financing in Chapter 11 of the US *Bankruptcy Code*.

³⁴ Canada, Industry Canada, Corporate and Insolvency Law Policy Directorate, *Report on the operation and administration of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act*, Ottawa, September 2002; available July 2003 on [http://strategis.ic.gc.ca/epic/internet/incilp-pdci.nsf/vwapi/3040-Bankruptcies.pdf/\\$FILE/3040-Bankruptcies.pdf](http://strategis.ic.gc.ca/epic/internet/incilp-pdci.nsf/vwapi/3040-Bankruptcies.pdf/$FILE/3040-Bankruptcies.pdf).

- Unpaid suppliers: as it stands, only suppliers of goods, not services, are given limited protection. Repossessing a service once performed, or information once provided, is difficult to say the least.
- UNCITRAL: should the model law on cross-border insolvencies of the UN Working Group on Insolvency Law replace Part III of the BIA? Reciprocity may be part of the answer.

The second group of issues is thought to be bridgeable by compromise and careful drafting and include the following:

- Survival of contracts: real property leases as well as software licenses pose some novel problems.
- Integration of the BIA and CCAA: This appears to be a matter of editorial neatness more than substance, as there is broad agreement that both the BIA and CCAA styles of reorganization ought to continue to exist – perhaps with better provision of information under the CCAA regime.
- Directors' liability: Is the balance between attracting capable directors (and retaining them when, in a crisis, they are most needed) and creating sufficient onus to focus their attention correct?
- Likewise, sanctions for director and officer conduct detrimental to creditors: are they optimal, given the same need for balance?
- Transfers at undervalue and unfair or fraudulent preferences: these provisions have not been updated since 1919.

Finally, there were a number of uncontroversial, largely technical items that will almost certainly be added to the eventual Bill:

- Securities firm bankruptcies: there needs to be a better definition of customer name securities to give certainty to Registered Retirement Savings (and Education) Plan holdings, and trustees should be allowed to sell securities and distribute proceeds in cash rather than as securities.
- WUA: There is consensus that the *Winding-up Act* should be used only in the insolvency of a financial institution.
- Should stays of legal proceedings during reorganization apply to provincial regulators such as securities commissions and stock exchanges? No.
- Trustee liability for successor employer obligations and pension claims: there is broad agreement that the moves to circumscribe trustee liabilities in 1992 and 1997 should cover these remaining open-ended liabilities.
- Supervision of reorganizations under the CCAA: It is likely that the Superintendent will be called on to supplement the work of the court by keeping records in a national and public registry, require monitors to be qualified trustees, handle complaints, and intervene at court when necessary. In this way the presently scattered and inconsistent public records of CCAA actions can be brought up to BIA standards, leading among other things to better possibilities for research and analysis.
- Funding and operations of the Office of the Superintendent of Bankruptcy: New money and permission to use new technology is needed.

These issues are discussed in the Industry Canada report cited above. Another matter which may arise concerns the rules for the calculation of contingent liabilities and the degree to which they are to be taken into account in determining solvency. It is sometimes possible for new public policy, legal decisions, or other 'accidents' to lead a firm's management to choose

a strategic bankruptcy or other disruption of normal commercial proceedings. This has been a problem in the US in the case of product liability suits, where courts have awarded astonishingly large damages, and may be the reason why the Ontario government has been unable to privatize Ontario Power Generation. In this case, despite (or perhaps because of) new federal legislation, the environmental liabilities for nuclear waste management are not calculable.

Matters of special interest in Russia

With the foregoing as background, we turn to some specific questions raised by IET researchers and summarize the relevant Canadian experience.

In general, how is probity assured? How are the interests of all parties, including owners, assured?

The proximal answer is that disinterested professionals are interposed between creditors and debtors: trustees, judges and receivers. Strongly reinforcing the probity of these professionals is the extensive transparency afforded bankruptcy cases, with forced disclosure of relevant information to all parties, the involvement of all creditors on a committee and the delegation of some of their powers to inspectors. Simply put, there are too many players involved in a corporate bankruptcy to allow improper behaviour to pass unnoticed.

How are receivers and trustees regulated?

A senior federal official, the Superintendent of Bankruptcy, whose office has extensive and detailed oversight of trustee activities, regulates trustees. The Superintendent establishes standards for the training of trustees, examines them, grants licenses as long as their professional qualifications continue to meet the established standards, hears complaints and where necessary takes disciplinary action.

How are priorities for the distribution of bankrupt estates established?

These contentious priorities, including those of the state itself, are established by Parliament under Section 136 of the BIA.

Has an insurance fund been considered to protect certain classes of creditors from malfeasance by regulated officials?

No; in such a case, a creditor would have a claim against the tortious official, and perhaps against the Superintendent if there has been negligent oversight. If malfeasance is by a civil servant the Crown may be sued. There has from time to time been consideration of a special fund, perhaps an offshoot of the Employment Insurance scheme, which would bear the costs of a super-priority to unpaid wage claims, but that is another matter. Malfeasance of this kind is quite rare.

How are insolvent state corporations dealt with?

If such corporations are “agents of Her Majesty,” the normal case, they operate with the full faith and credit of the state. Insolvency is thus impossible in principle, as there is no end to the credit that will be extended in such a case. In practice, the federal Treasury Board Secretariat and Department of Finance exercise sufficient controls over Crown corporations that threatening situations are dealt with before they become dangerous. Two examples: when the federal government privatized the Canadian National Railway in 1996 it was necessary to “clean up its balance sheet” quite substantially before a reasonable sale could be concluded. And the concentration of exposures on the books of the Export Development Corporation is such that it is unlikely that it could borrow at reasonable rates without reliance on the financial resources of the government as a whole.

There are a small number of cases where the government owns a company or an interest in a company that is expressly declared not to be an agent. In such cases the ordinary procedures of the BIA or CCAA would apply. Needless to say, this would be an embarrassment, so

reasonable oversight is maintained to ensure that problems are dealt with before they become notorious.

Are particular sectors dealt with differently?

Companies with more than \$5 million in liabilities may use the provisions of CCAA or the BIA, but not both. All others, with the exception of financial corporations who would use the *Winding Up and Restructuring Act*, must use the BIA. Other than that, no distinctions are made on a sectoral, geographical, or sole-employer basis.

Do the provinces play any role?

Section 91(21) of the *Constitution Act, 1867* assigns bankruptcy exclusively to the federal government. However, it also assigns matters of property and civil rights to the provinces. Where they tend to meet is in respect of the exemptions from seizure in personal bankruptcies, where individual provinces (as states in the United States) may have somewhat different lists, and in some of the broader aspects of creditor-debtor law. In these cases, courts will defer to the law most closely related to the constitutional basis on which it is erected. A large volume of case law provides a high degree of certainty.

Provinces will act as any interested creditor group when priorities are at issue in legislative amendments. They sought and won a super-priority for environmental damage in 1997, and insist that their other Crown super-priorities rank *pari passu* with the federal government. Their protection does not, however, extend to their legislative creatures the municipalities, who must take their place in the dreary queue of ordinary creditors.

What about international conflicts in law and the recognition of foreign bankruptcy decrees?

This is a matter of evolving practice, principally involving trans-border bankruptcies where assets are located in both the US and Canada,³⁵ although other genuinely multi-national cases, such as those of the airlines, have been testing the framework lately. Under the BIA/CCAA reforms of 1997, the steps courts had been taking on a case-by-case basis to recognize and coordinate with procedures in other countries received statutory blessing. Canada has been an active participant in the United Nations Commission on International Trade Law (UNCITRAL) and its proposed model law on international insolvencies may be adopted soon, perhaps on a basis of reciprocity.

What are the responsibilities of parent corporations toward failing subsidiaries and their creditors?

In general, these are defined as matters of contract law. The creditors of a failing subsidiary cannot call on the resources of the parent absent an explicit guarantee; indeed one of the reasons for elaborate corporate group structures is to isolate certain risks. Project finance agreements, for example, usually specify limited or no recourse beyond the resources of the project itself.

As a matter of good corporate governance, of course, a parent corporation would normally exercise such oversight over the activities of a subsidiary as to take corrective measures before a risky situation descended into bankruptcy. For most companies, reputational risk is consciously planned for.

What are the personal liabilities of directors and officers of a company that is insolvent or in the vicinity of insolvency?

Directors are liable during a bankruptcy for unpaid wages, unremitted payroll deductions for taxes, Employment Insurance and the Canada Pension Plan, and for dividends paid or other transactions that do not meet a financial test if the company is insolvent. For all these

³⁵ The US side has given attention to practical procedures for such cases: cf. American Law Institute, Transnational Insolvency Project, "Principles of cooperation in transnational insolvency cases among the members of the North American Free Trade Agreement," Philadelphia, 2000.

matters a due diligence defence is available and would normally be covered by an indemnity from the company or by standard Directors' and Officers' liability insurance. Directors are also liable for many other items in the ordinary course of business,³⁶ but these are the special ones that are likely to arise in the context of a bankruptcy.

³⁶ McCarthy Tétrault, *Directors' and officers' liabilities in Canada*, Butterworths, Toronto, 1997

Annex A: The ten acts of bankruptcy

According to Section 42 of the BIA, a debtor company commits an act of bankruptcy if, in the six months before the filing of the petition:

- in Canada or elsewhere it makes an assignment of its property to a trustee for the benefit of its creditors generally, whether it is an assignment authorized by the Act or not;
- in Canada or elsewhere it makes a fraudulent conveyance, gift, delivery, or transfer of its property or any part thereof;
- in Canada or elsewhere it makes any conveyance or transfer of its property or any part thereof, or creates any charge thereon, that would under this Act be void as a fraudulent preference;
- (for individuals:) with intent to defeat or delay its creditors, he departs out of Canada, or, being out of Canada, remains out of Canada, or departs from his dwelling-house or otherwise absents himself;
- the debtor permits any execution or process issued against the debtor under which any of the debtor's property is seized, levied on or taken in execution to remain unsatisfied until within five days from the time fixed by the sheriff for the sale thereof or for fifteen days after the seizure, levy or taking in execution, or if any of the debtor's property has been sold by the sheriff, or if the execution of other process has been held by the sheriff for a period of fifteen days after written demand for payment without seizure, levy or taking in execution or satisfaction by payment, or if it is returned endorsed to the effect that the sheriff can find no property whereon to levy or to seize or take, but where interpleader proceedings have been instituted with respect to the property seized, the time elapsing between the date at which the proceedings were instituted and the date at which the proceedings are finally disposed of, settled or abandoned shall not be taken into account in calculating the period of fifteen days;
- it exhibits to any meeting of its creditors any statement of its assets and liabilities that shows that it is insolvent, or presents or causes to be presented to any such meeting a written admission of its inability to pay its debts;
- it assigns, removes, secretes or disposes of or attempts or is about to assign, remove, secrete or dispose of any of its property with intent to defraud, defeat or delay its creditors or any of them;
- it gives notice to any of its creditors that it has suspended or is about to suspend payment of its debts;
- it defaults in any proposal made under this Act; and
- it ceases to meet its liabilities generally as they become due.

Since 1997, the suspension by a regulatory authority of a securities firm for capital inadequacy has constituted an eleventh act of bankruptcy.

As any of these acts are criminal in nature, the onus of proof lies on the petitioning creditor(s), and the judge must hold a hearing on the proof of statements in the petition if the matter is opposed.

Annex B: Powers and liabilities of trustees under the BIA

Dunphy provides the following succinct description:³⁷

The function of the trustee is to take possession of the deeds, books, records and documents and all property of the bankrupt as quickly as possible...and to make an inventory of all of the property of the bankrupt. The trustee should change the locks on the bankrupt's property and redirect mail and in this regard, the trustee is in the same position as if he were a receiver of the property of the bankrupt appointed by the court. In addition, the trustee possesses various remedies to recover property of the bankrupt that is in the hands of third parties [...subject to] the rights of secured creditors... [A] trustee in bankruptcy may not oust a receiver appointed by a creditor with valid security.

Once the trustee has gathered in the property of the bankrupt, the trustee is obliged to realize upon it and distribute the proceeds to the creditors of the bankrupt in accordance with the priority of distribution established in the BIA.

Prior to the first meeting of creditors, the trustee may dispose of property that is perishable or is likely to depreciate rapidly in value and may carry on the business of the bankrupt.

Subject to such extension as the court may grant, it is the duty of the trustee to prepare a list of creditors as soon as possible after the bankruptcy and, within five days after the trustee's appointment, to send to creditors and the Superintendent notice of a first meeting of creditors which in turn is to be held within twenty-one days of the trustee's appointment. At their first meeting [chaired by the Official Receiver], the creditors will vote upon the appointment of at least one and up to five inspectors of the estate of the bankrupt. The inspectors provide advice and directions to the trustee, subject to the authority of the creditors at a meeting or the bankruptcy court to override such directions...

Following the first meeting of the creditors the trustee can, with the permission of the inspectors, sell the property of the bankrupt, lease real property, carry on the business of the bankrupt, bring or defend any action or other legal proceedings relating to the property of the bankrupt, engage a solicitor or agent to conduct business sanctioned by the inspectors, accept security from debtors of the estate, incur obligations, borrow money and give security on the property of the bankrupt, compromise debts and claims, divide property among the creditors which cannot be easily sold, elect to retain, assign, surrender or disclaim any lease of any property of the bankrupt and appoint the bankrupt to aid in the administration of the estate on such terms as the inspectors may direct.

In carrying on the business of the bankrupt, it is possible for the trustee to incur personal liability. For this reason, trustees will normally contract in their capacity as trustees only, and specifically stipulate that they are not acting in their personal capacity. However, not all personal liability can be contracted out of...

The trustee is not personally liable for environmental damage occurring before the trustee's appointment or after the appointment unless it was the result of the trustee's failure to exercise due diligence; but, the trustee is obliged to make any report or disclosure required by federal or provincial legislation.

³⁷ *Op. cit.*, §12.02[3][c][iv]

The bankrupt or any of the creditors or any other person aggrieved by any act of the trustee can apply to the court and the court may confirm, reverse, or modify the act complained of; but, the trustee is protected by the court against improper, frivolous and vexatious suits or proceedings arising out of the administration of the estate.

If a trustee refuses or neglects to take any proceeding which a creditor requests the trustee to take...the creditor may obtain from the court an order authorizing the creditor to take the proceeding in the creditor's name and at the creditor's expense. In order to take such a step, all other creditors of the bankrupt must be afforded an opportunity to participate in the proceeding. The fruits of such a proceeding, if any, belong to participating creditors to the full extent of the claim after expenses. The balance, if any, reverts to the estate.

A trustee is a private professional. As such, it is up to the creditors to strike a bargain over fees and expenses, which are paid out of the estate and therefore reduce the creditors' recovery. As trustees' risks and liabilities can be large and only partly mitigated by insurance, itself not cheap, their fees can be considerable. In this respect, the limitation of environmental liability in the 1997 amendments played an important role in moderating fees, and indeed in persuading trustees to take on certain cases at all.

Annex C: Statutory priorities in business insolvencies

Section 136 of the BIA establishes the following priorities for the distribution of money from the bankrupt estate. All claims of a higher class are paid before any claims of the next class.

1. **Super-priorities:**
 - (a) Compensation to the Crown for the costs of environmental damage
 - (b) Unremitted wage deductions for Canada Pension Plan and employment insurance premiums, and for employee tax withholdings
 - (c) Fees and expenses of the trustee
2. **Secured creditors**
3. **Preferred creditors**
 - (a) Funeral expenses of the bankrupt, if applicable
 - (b) Costs of administering the bankruptcy (trustees' fees and legal expenses)
 - (c) Levy on all estates to help defray the expenses of the Office of the Superintendent of Bankruptcy
 - (d) Wage claims up to \$2,000, plus \$1,000 in salesmen's expenses
 - (e) Alimony and maintenance claims
 - (f) Municipal taxes
 - (g) Landlords' claims for rent
 - (h) Costs of the creditor who first executed against the debtor, and
 - (i) Claims of workers not covered by Workers' Compensation
4. **Ordinary (other unsecured) creditors**
5. **Preferred shareholders**
6. **Common shareholders**