Report on the Operation and Administration of the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*

September 2002
Marketplace Framework Policy Branch
Policy Sector

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Cat. No. Iu4-3/2002
ISBN 0-662-66932-0
53678B

PRINTED IN CANADA
IMPRIMÉ AU CANADA

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EXECUTIVE SUMMARY

INTRODUCTION In 1997, amendments to section 216 of the *Bankruptcy and Insolvency Act* (*BIA*) and section 22 of the *Companies' Creditors Arrangement Act* (*CCAA*) included a provision that both Acts would be referred to a Committee of Parliament for review five years after coming into force. That five-year period expired on April 25, 2002.

Industry Canada has prepared this report on the operation and administration of the *BIA* and the *CCAA*. The report summarizes for the Committee the issues that stakeholders identified as concerns. It contains no recommendations, because its purpose is to present issues and potential policy options to the Committee for deliberation and recommendations.

OVERVIEW Canada has three main insolvency statutes, each with distinct purposes: the *BIA*, the *CCAA* and the *Winding-up and Restructuring Act*, which is not the subject of statutory review at this time. The *BIA* is an all-encompassing Act providing for both personal and corporate insolvencies. It offers various alternatives, from outright bankruptcy for individuals or corporations to less extreme consumer proposals for individuals and reorganizations for businesses. The *CCAA* applies to reorganizations of corporations having over $5 million in debt. These reorganizations can proceed either under Part III of the *BIA* or under the *CCAA*. Unlike reorganizations under the *BIA*, the *CCAA* provides for a court-driven process that allows judges a high degree of flexibility in determining how best to deal with the specific cases before them.

Canada's existing insolvency legislation has its roots in the *Bankruptcy Act* of 1919, which was substantially revised in 1949 and more recently in 1992 and 1997. The *CCAA* came into being in 1933, but was not frequently used until the mid-1980s. Since that time it has become a popular means of reorganizing a corporation. It too was amended in 1997.

Insolvency statutes have an important role to play in the Canadian economy. Over the past 30 years, the total number of filings with the Office of the Superintendent of Bankruptcy Canada (OSB) have increased from less than 10 000 annually in 1971 to almost 100 000 in 2001. In 2001 alone, the liabilities of people and businesses who became bankrupt or filed a proposal under the *BIA* involved almost $13 billion.

The *BIA* and *CCAA* form part of Canada's marketplace framework laws, helping to govern commercial relationships whether personal or business. Therefore, it is important to consider the impact of these laws beyond the results of a specific insolvency. Insolvency rules offer some security for investors and lenders in both commercial and consumer credit markets. This in turn affects credit rates and availability. In the commercial sphere, the certainty and reliability of the insolvency system play a role in attracting domestic and foreign investment as well as in promoting entrepreneurship and innovation. The efficiency with which the insolvency system enables assets to be redeployed improves overall economic performance. The speed, transparency and fairness with which assets are disposed of help to minimize the harm to the creditors and ensure integrity in the insolvency proceedings. Certain and reliable insolvency rules also improve the efficiency of consumer credit markets, enabling individual borrowers to obtain the funds they need for personal investment and consumption at reasonable cost.

The principal consideration in an era of increased competitiveness is how to make the insolvency process as efficient as possible for those faced with insolvency, while maintaining fairness. In the knowledge-based economy, there is an increasing need for the quick and frequent redeployment of assets from insolvent businesses to new and profitable ventures. The market generally is effective in redeploying assets to their best uses. However, sometimes assets are not appropriately redeployed. By overcoming some of these shortcomings, bankruptcy law can improve both efficiency and fairness in commercial insolvencies.

Similar concerns also exist in consumer credit markets. Consumers may lack the information required to make good borrowing decisions and some elements of the consumer credit market may lack vigorous competition. Insolvency law can help overcome these problems.

ADMINISTRATIVE POLICY ISSUES The OSB is directed by the *BIA* to supervise the administration of estates under the Act, keep records of proceedings, investigate complaints and oversee the trustees in bankruptcy who administer bankruptcy estates. The OSB's responsibilities and powers were substantially increased by the amendments made to the *BIA* in 1992 and 1997.

The OSB has identified seven areas of concern involving the administration of the insolvency system as a whole: 1) the high volume of files, particularly in consumer bankruptcies, which shows no sign of abating; 2) access to the insolvency system, which is increasingly difficult for low-asset low-income debtors; 3) debtor compliance, which is difficult to ensure given the rising caseload, increasing complexity of cases and scarcity of resources; 4) regulatory supervision, which is not provided for at all in the *CCAA*; 5) regulatory supervision of receiverships under current *BIA* rules; 6) funding of OSB operations, which is made difficult by statutory and administrative constraints; and 7) new technology, whose adoption is being impeded by *BIA* restrictions.

COMMERCIAL INSOLVENCY ISSUES The commercial issues discussed in this report can be broadly grouped into three categories. The first category includes the most contentious issues — those that continue to evoke views very much opposed to one another and not easily resolved. The most controversial are wage-earner and pension protection; debtor-in-possession financing; unpaid suppliers rights; and the adoption of the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvencies.

The second category represents the issues where significant differences exist among stakeholder views. These differences do not appear to be insurmountable and can likely be resolved to general satisfaction through technical amendments. Issues in this category are the extent to which the exercise of contractual rights should be constrained in insolvencies; integration of the *BIA* and *CCAA*; directors' liability; sanctions for director and officer conduct detrimental to creditors; and transfers at undervalue and preferences.

The third category contains those issues that through the consultation process received general support for a specific course of action. They include securities firm bankruptcies; limiting access to the *Winding-up and Restructuring Act* for insolvency purposes to insolvent financial institutions; the financial market issue about whether securities commissions and exchanges should be exempt from *BIA* and *CCAA* stays; and protection for trustees against personal liability as successor employers.

This report outlines the findings from these consultations on commercial insolvency issues in meetings across Canada that were attended by over 200 interested stakeholders. Industry Canada distributed three discussion papers before the consultations and has received comments on the issues raised in the papers, in both written submissions and in the consultations themselves. Small and large businesses, academics, lawyers, judges, financial institutions, the credit industry, labour, and various federal and provincial government agencies have all contributed.

CONSUMER INSOLVENCY ISSUES Consumer insolvency issues have been examined in a manner similar to that used for commercial issues. A discussion paper on various issues and options was issued in May 2002 and posted on the Industry Canada Web site as a means of stimulating debate. This was followed by public consultations in the spring of 2002, which attracted approximately 250 participants from diverse backgrounds.

Consumer insolvency issues have also been examined by the Personal Insolvency Task Force (Task Force), an independent panel established by the OSB with membership from various stakeholder groups. The draft report of the Task Force was considered by the Department in preparing the discussion paper.

The consumer issues discussed in this report have also been grouped according to the degree of consensus among stakeholders. The first, and most contentious group, includes the federal exemptions issue and whether Registered Retirement Savings Plans (RRSPs) should be exempt.

The second group is made up of those issues for which a reasonable consensus exists in principle, subject to working out appropriate technical details. This group encompasses reaffirmation agreements; the streamlining of summary administration bankruptcies; the exemption of Registered Education Savings Plans (RESPs); the enforcement of security on a bankrupt's household property; and mandatory counselling.

The final group includes those issues for which a high degree of consensus emerged, and for which little or no opposition was displayed during consultations. These issues are consumer liens, growth in consumer bankruptcies, student loans, and wage assignments.

It is the stated intention of the Government of Canada to make sure that Canadian laws and regulations remain among the most modern and progressive in the world, and Industry Canada would welcome any guidance or recommendations that the Committee may offer.

I. INTRODUCTION

Canada has three main insolvency statutes, each with distinct purposes: the *Bankruptcy and Insolvency Act* (*BIA*), the *Companies' Creditors Arrangement Act* (*CCAA*) and the *Winding-up and Restructuring Act*. In 1997, amendments to section 216 of the *BIA* and section 22 of the *CCAA* included a provision that both Acts would be referred to a Committee of Parliament for review, five years after coming into force. That five-year period expired on April 25, 2002. The *Winding-up and Restructuring Act*, which is primarily the tool of financial institutions and not-for-profit agencies, is not the subject of mandatory review at this time.

The significance of these Acts and any possible reforms should not be overlooked. Canada has a highly regarded insolvency system. It is frequently cited as a model in international insolvency panels, such as the United Nations Commission on International Trade Law (UNCITRAL), and is one of only three insolvency systems exhibited on the World Bank Web site. Indeed, the World Bank describes the Canadian system as "a uniquely Canadian multinational insolvency regime which focuses on cooperation and coordination."

Given the respect that Canada's insolvency legislation and system have received internationally and their important role in the economy, it is important that the Acts continue to reflect the intention of the Government of Canada to make sure that Canadian laws and regulations remain among the most modern and progressive in the world.[1] The role of the Committee in achieving this goal is considerable and Industry Canada would welcome any guidance or recommendations that the Committee may offer.

1. Speech from the Throne, January 30, 2001.

Although the *CCAA* was amended in 1997 and the *BIA* in 1992 and 1997, those amendments were not comprehensive. Some issues remained outstanding, while others have emerged since that time. In this report, the discussion is grouped under three headings:

1. administrative policy issues;
2. commercial insolvency issues; and
3. consumer insolvency issues.

The administrative policy issues highlight procedural obstacles raised by stakeholders during various meetings, including national forums on insolvency. Some of these issues relate to the needs of the Office of the Superintendent of Bankruptcy Canada (OSB) if it is to administer the system effectively, while others involve the impediments faced by stakeholders that can be improved or simplified.

The commercial insolvency issues can be broadly grouped into three categories. The first includes the most contentious issues — those that continue to evoke views very opposed to one another and not easily resolved. These issues are wage-earner and pension protection, debtor-in-possession financing, unpaid suppliers rights, and the adoption of the UNCITRAL Model Law on Cross-Border Insolvencies. The second category represents the issues where significant differences exist among stakeholder views. These differences do not appear to be insurmountable. The final category contains those issues that received general support for a specific course of action.

The commercial issues portion of this report is the result of continuing stakeholder consultations, responses to three discussion papers, and meetings across Canada that were attended by over 200 interested stakeholders. Industry Canada has received comments and contributions from small and large businesses, academics, lawyers, judges, financial institutions, the credit industry, labour, and various federal and provincial government agencies. We are indebted to all parties who participated in the process.

The same consultation process was carried out for consumer insolvency issues, with approximately 250 stakeholders participating. In addition, these issues have been examined by the Personal Insolvency Task Force (Task Force), an independent panel established by the OSB with membership from various stakeholder groups. The draft report of the Task Force was considered by Industry Canada in preparing the departmental discussion paper.

Consumer insolvency issues were also grouped according to the degree of stakeholder consensus. The issues exhibiting no clearly preferred option were federal exemptions and the exemption of RRSPs. Those with more modest differences that can likely be resolved are reaffirmation agreements, the streamlining of summary administration bankruptcies, the exemption of RESPs, the enforcement of security on a bankrupt's household property, and mandatory counselling. The final group, which offered a high degree of agreement among stakeholders, includes consumer liens, growth in consumer bankruptcies, student loans, and wage assignments.

II. OVERVIEW

1. BACKGROUND

The Bankruptcy and Insolvency Act

The *BIA* is an all-encompassing Act for both personal and corporate insolvencies. It offers various alternatives, from outright bankruptcy for individuals or corporations to less extreme consumer proposals for individuals and reorganizations for corporations. The various alternatives are meant to reflect the seriousness of the financial problems being experienced by the debtor and to offer a degree of protection to the creditors.

Where no hope remains of restoring an insolvent person or corporation to financial viability, bankruptcy is a means of liquidating the assets for the benefit of the creditors, providing the debtor with a fresh start, and getting the assets back to work in a profitable environment. Where restoration is possible, the *BIA* provides both consumers and corporations of any size with the means to make a proposal to their creditors to restructure their debt. These are commonly known as "consumer proposals" for consumers and "reorganizations" for corporations. Proposals and reorganizations generally result in a greater return to creditors, while allowing the individual or business to continue to function and to recover. In both bankruptcies and reorganizations, the *BIA* provides a structured system and ensures a fairly predictable and consistent outcome.

The Companies' Creditors Arrangement Act

The *CCAA* applies only to corporate reorganizations involving more than $5 million in debt. In these cases, the reorganization can proceed either under Part III of the *BIA* or under the *CCAA*. Unlike reorganizations under the *BIA*, the *CCAA* provides for a court-driven process that allows judges a high degree of flexibility in determining how best to deal with the specific cases before them. The *CCAA* provides a general framework to allow for a reorganization, while the *BIA* has more specific rules for reorganization.

The benefits of a successful reorganization are the expectation of a greater return to creditors than in bankruptcy, profitable continuation of the business, and the maintenance of jobs. If a reorganization is unsuccessful, bankruptcy would usually follow.

2. HISTORY

Canada's existing insolvency legislation has its roots in the *Bankruptcy Act* of 1919, which was substantially revised in 1949 and more recently in 1992 and 1997. The *CCAA* came into being in 1933, but it has only been since the mid-1980s that it has been popular as a means of reorganizing a business. It too was amended in 1997 (see Appendix A for details).

Although the *BIA* contains provisions for reorganizations, at the time the *CCAA* came into being the provisions were only available to companies that were actually bankrupt. The *CCAA* was an alternative for companies that may be insolvent but not actually bankrupt. This distinction has since been removed. The only substantial difference in making use of the two statutes is that to start a *CCAA* proceeding, the debtor corporation must have at least $5 million in debts.

The 1992 changes focussed on:

- maximizing value through reorganization and rehabilitation;
- improving the equitable distribution to suppliers and employees; and
- improving administration of the *BIA*.

The 1997 reforms:

- encouraged consumer debtor responsibility;
- improved the reorganization provisions; and
- further improved the administration of the Acts, including the administration of securities firm bankruptcies and international insolvencies.

While substantive, these changes were not comprehensive. The intention was to modify the Acts over time, addressing concerns based both on priority and on the ability to identify a means of correcting specific problems. Resolving concerns is particularly difficult in insolvency law because the fundamental issue is a shortfall of money. Any attempt to improve the circumstance of one stakeholder comes at the expense of another. This makes the balancing of fairness among the parties particularly difficult.

3. ECONOMIC IMPLICATIONS

The *BIA* and *CCAA* form part of Canada's marketplace framework laws, helping to govern our commercial relationships for both consumers and businesses. Therefore, it is important to consider the impact of these laws beyond the results of a specific insolvency.

Since 1992, total liabilities found in consumer insolvencies averaged approximately 0.5 percent of the Canadian gross domestic product (GDP).[2] At the end of the recession in 1992, liabilities for business insolvencies amounted to 1.2 percent of GDP. It then dropped to 0.5 percent of the GDP in 1999 and has now increased to 0.8 percent in 2001.

2. OSB database.

Bankruptcy and reorganization rules offer some security for investors and lenders in both commercial and consumer credit markets. This in turn affects credit rates and credit availability for business and consumer borrowers. In the commercial sphere, the certainty and reliability of the insolvency system play a role in attracting both domestic and foreign investment as well as in promoting entrepreneurship and innovation. The efficiency with which the insolvency system enables assets to be redeployed improves overall economic performance. The speed, transparency and fairness with which assets are disposed of help to minimize the harm to the creditors and make sure of the integrity in the proceedings. Certain and reliable insolvency rules also enhance the efficiency of consumer credit markets, enabling individual borrowers to obtain the funds they need for personal investment and consumption at reasonable cost.

Typically, bankruptcy is viewed negatively, signifying failure. The effect is felt by all those involved with the business or individual. Employees lose their jobs and sometimes remain unpaid, suppliers absorb a loss, lenders may not recover the full amounts owed, and the losses may put some of these groups at risk for bankruptcy themselves. Even the survival of smaller communities can be put in jeopardy. Reorganizations, if successful, offer some relief from these effects, but losses are still sustained.

A consumer bankruptcy has less impact on the community as a whole, but imposes severe financial constraints on the bankrupt and his or her family. The fresh start provided by insolvency legislation is an important safety net for consumer borrowers.

The principal consideration in an era of increased competitiveness is how to make the insolvency process as efficient as possible for those faced with insolvency, while maintaining fairness. In the knowledge-based economy, there may be an increasing need for the quick redeployment of assets to new and profitable ventures. Although broad economic considerations are important, it is essential not to lose sight of the individuals and businesses who are affected by these events and who must be dealt with fairly.

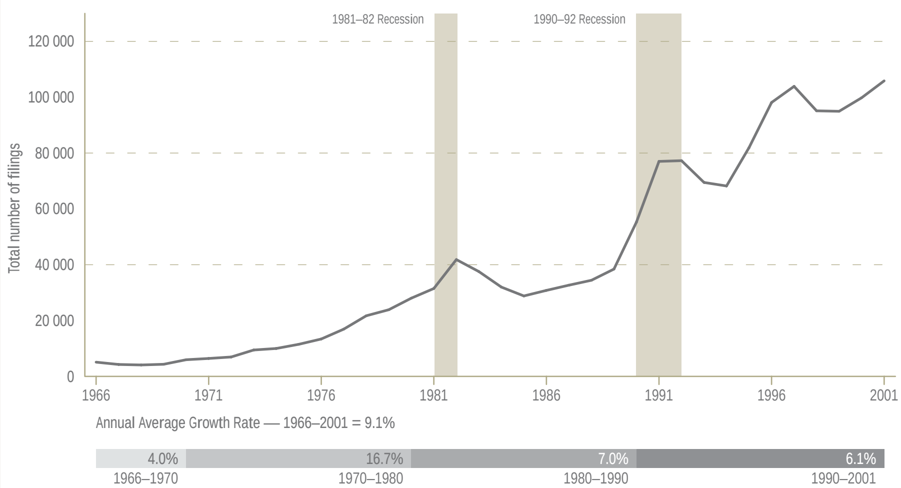
The market can sometimes fail to take into account certain side effects in a commercial bankruptcy situation. These side effects, or externalities, include such things as the

3. The total of consumer filings, business filings, Division I and II proposals since 1993 and existing proposals before 1993; Division I concerns reorganizations, and Division II involves consumer proposals.
4. Consumer bankruptcies and Division II proposals.
5. Business bankruptcies, Division I proposals and pre-1993 proposals.

impact of geographic redeployment of the assets and the effects on other businesses and the community. Creditors, who are especially sensitive to risks, may want to act quickly and seize the secured assets, thus pushing the business closer to a bankruptcy that might otherwise be avoided. Insolvency law provides various rules to help reduce some of these obstacles to an efficient market.

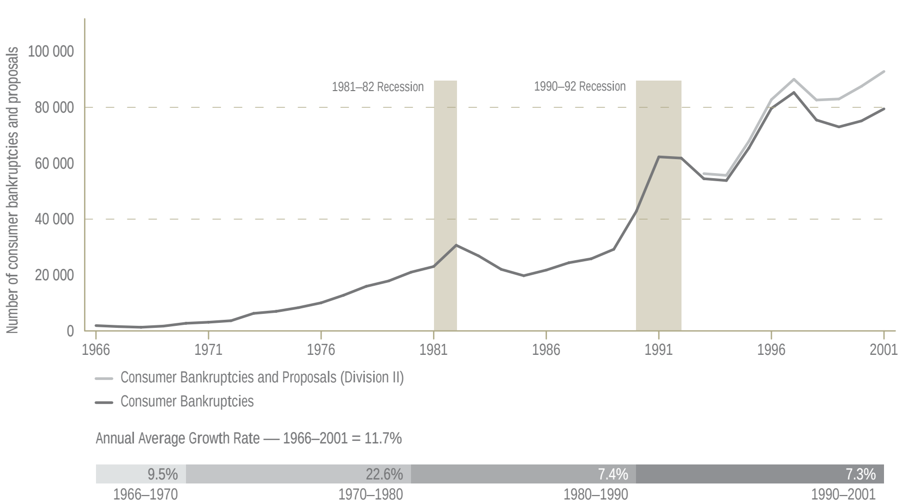
In many cases it is preferable to avoid bankruptcies through the use of business reorganizations or consumer proposals. If a reorganization or proposal will not likely succeed and bankruptcy is the only reasonable approach, an objective of an insolvency regime should be to ensure a fair, efficient and predictable disposition of the assets, while minimizing the hardships experienced by various stakeholders.

Figure 1:
Total Number of Filings, Canada, 1966–2001



Source: Office of the Superintendent of Bankruptcy Canada, Industry Canada.

Figure 2:
Number of Consumer Bankruptcies and Proposals, Canada, 1966–2001



Source: Office of the Superintendent of Bankruptcy Canada, Industry Canada.

4. TRENDS IN INSOLVENCIES

Over the past 35 years, the total number of filings[3] with the OSB has increased by an average of 9.1 percent per year (Figure 1). However, this rate of increase has slowed over the decades: it was 16.7 percent during the 1970s, 7.0 percent during the 1980s and 6.1 percent between 1990 and 2001.

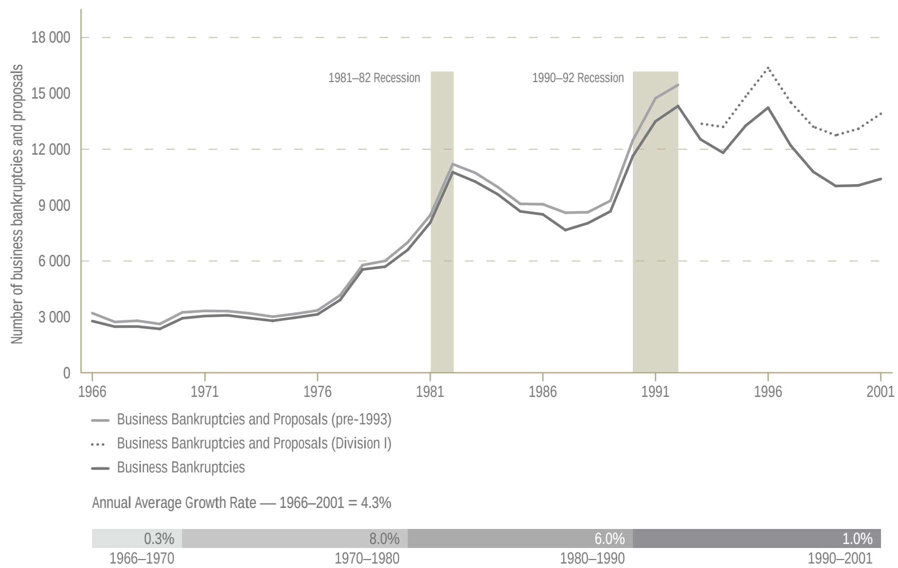
Between 1966 and 2001, the growth in consumer filings[4] (11.7 percent, Figure 2) was greater than the growth in business filings[5] (4.3 percent, Figure 3). As with the filings as a whole, the growth in consumer and business filings slowed since 1980. In 1993, proposals were divided into two distinct categories: business proposals (under Division I) and consumer proposals (under Division II). The average annual rates of increase in business and consumer proposal filings since 1993 were 19.4 percent and 28.3 percent, respectively. Over the same period, the average annual growth in consumer bankruptcy filings was 4.8 percent, whereas business bankruptcy filings declined by an average of 2.3 percent per year.

The shaded regions in Figures 1, 2 and 3 mark the periods of economic slowdown in the early 1980s and 1990s. During both periods, there was an increase in the number of filings. The pickup in economic activity that followed these periods tended to offset that increase. The evidence therefore shows that variations in economic activity temporarily affect the number of filings. Structural factors — such as population growth, number of businesses and number of self-employed workers — may account for some of the increase in filings. For example, since 1980 the population has increased by 33 percent, while consumer insolvency filings increased by 403 percent. In addition, the increase in the indebtedness ratio[6] from 61 percent in 1984 to 95 percent in 2001 may also account for part of the increase in the number of consumer filings.

Since 1971, consumer bankruptcy filings with the OSB accounted for a greater share of the total than did business bankruptcy filings (Figure 4). Since 1976, roughly 70 percent to 80 percent of filings with the OSB have been consumer bankruptcies.

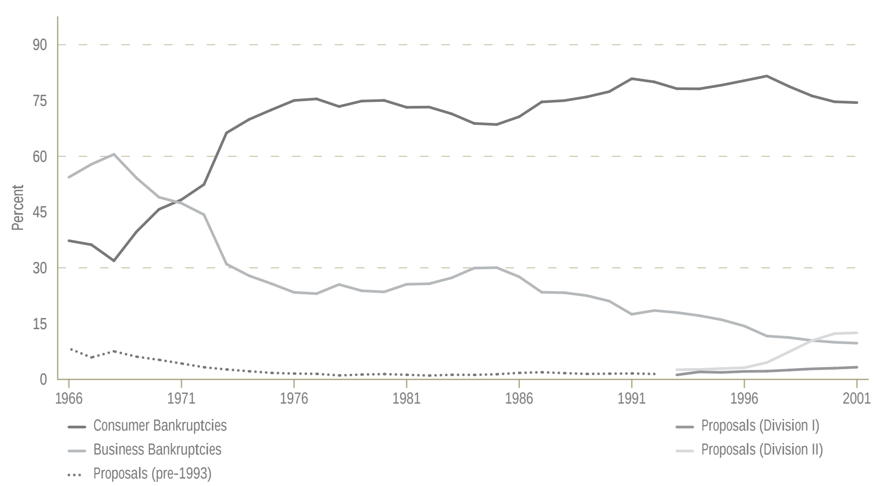
6. This ratio is equal to the sum of consumer and mortgage credit, divided by personal disposable income.

Figure 3:
Number of Business Bankruptcies and Proposals, Canada, 1966–2001



Source: Office of the Superintendent of Bankruptcy Canada, Industry Canada.

Figure 4:
Distribution of Business and Consumer Bankruptcies and Proposals, Canada, 1966–2001



Source: Office of the Superintendent of Bankruptcy Canada, Industry Canada.

III. ADMINISTRATIVE POLICY ISSUES

The *BIA* gives the Superintendent of Bankruptcy the mandate to "supervise the administration of all estates and matters to which this Act applies." The *BIA* charges the Superintendent with the supervision of bankruptcy estates, business reorganizations, consumer proposals and receiverships. The Superintendent must keep a publicly accessible record of insolvency proceedings (more than 100 000 new filings are added each year) and a record of complaints from creditors, debtors and the general public, and it must conduct investigations where necessary. The Superintendent also licenses and oversees administrations by roughly 900 private-sector trustees, and establishes and implements professional standards for the administration of estates with a view to preserving the integrity of Canada's insolvency system.

The OSB has three broad areas of activity. First, it must ensure a soundly operating insolvency process supported by an effective regulatory framework. Second, it must ensure compliance with insolvency legislation by discouraging offences and fraud and encouraging stakeholders to abide by the legislation. And third, it must provide the administrative infrastructure required by the *BIA*.

The OSB's legislative framework has evolved with changes in the economic, social and political environment. The *BIA* has undergone two major revisions in the past decade. One effect of these revisions has been to broaden the OSB's mandate. The first revision, carried out in 1992, amended the Act to expand or clarify the Superintendent's powers to carry out the OSB's legislated mandate to include:

- the issuance of such directives required to give effect to any decision made under the *BIA*, along with the provision that the persons to whom those directives apply must comply with them;
- jurisdiction over all aspects of trustee licensing;
- authority to require the trustee to submit their account final statement of receipts and disbursements to the courts for taxation; and
- jurisdiction to supervise receiverships.

The second revision was carried out in 1997. Though more modest than the first, it also expanded the role of the Superintendent by:

- clarifying the jurisdiction of the Superintendent over certain aspects of licensing;
- requiring the Superintendent, through directives, to establish the formula for determining surplus income; and
- requiring that a mediation service be provided for disputes between debtors and their creditors concerning the share of the debtor's income payable to them.

As a result of comments received and various sessions conducted with stakeholders, including national insolvency forums held across the country in 1999, the Superintendent has identified seven areas that would benefit from review.

1. VOLUME OF INSOLVENCY FILES

The issue

The continued growth in the number of insolvency files over the past 35 years has given rise to concerns about the factors that have caused this growth. An issue is whether preventive approaches should be sought to counter the upward trend in the volume of insolvency filings and to encourage debtors to adopt better credit management practices to reduce the likelihood of insolvency.

Background

Total insolvency filings have increased by an average of just over 9 percent per year over the past 35 years. In 2001, the liabilities of businesses involved in proceedings under the Act amounted to $7.8 billion and the liabilities of consumers totalled $5.1 billion. Based on the indebtedness ratio of the Canadian public, there is every reason to believe that the number of insolvencies will continue to rise over the coming years.

The causes of insolvency are many and there are usually more than one of them in any specific case. However, a distinction must be drawn between business and personal insolvencies. Although business insolvencies are also affected by the specific environment of each business, it seems clear that the volume of business insolvencies is directly tied to the economic context. Indeed, weakness in trade and economic activity can easily lead a specific business to insolvency.

By contrast, the causes of personal insolvencies go beyond the economic context. Some are purely financial in nature, but others are related to the social or family context or simply to the insolvent person's conduct. Unemployment, unforeseen events, lifestyle, age, demographic profile, credit and interest rates are among the factors that have a significant bearing on the number of personal insolvencies. Under the credit heading alone, the number and diversity of financial products and their increasing complexity and relative ease of access contribute to a greater risk of financial difficulties for users.

The provincial and federal governments and private financial planning organizations already offer programs and services designed to prevent insolvency. The 1992 revision responded with certain measures, such as an obligation to offer consumer debtors a counselling service and the introduction of a new proposal process for debt settlement. These measures seek to solve some of the problems that stem from endemic debt, notably by providing education about good credit management or by favouring a consensual settlement of debts that is simple, effective and satisfactory for both debtors and their creditors.

The 1997 revision introduced the concepts of surplus income and mediation, thereby clarifying the fact that debtors who are able to do so have a responsibility to contribute a share of their income to the creditors as a whole, subject to a mediation service if they disagree on the amounts to be paid.

Admittedly, these measures only come into play when the individual is already insolvent. The issue is whether other preventive approaches should be sought to counter the upward trend in the volume of insolvencies and encourage debtors to adopt better credit management practices that make bankruptcy less likely to occur. Presently, the OSB only intervenes once insolvency has occurred. Several stakeholders — creditors, consumers' associations, insolvency practitioners and credit counsellors — have called for more sustained and coordinated efforts related to education and prevention.

Considerations

It is difficult to control the social and economic factors that contribute to insolvency. One can easily envisage a situation in which the OSB can handle an increasing caseload thanks to technological innovations, but where sustained volume growth stretches to the limit its ability to detect and stop abuses. If this happens, lenders and investors may lose confidence, and this could in turn increase the cost of credit and constrict the availability of financial products for all Canadians.

Access to credit counselling services at a suitable time and greater attention to education on financial management, would be important contributions to any program aimed at reducing excessive indebtedness. Studies conducted to date establish that appreciation for counselling services is growing both among authorized counsellors and by users. Many regret, however, that these services can only be offered at certain times and cannot be put to better use before a bankruptcy or insolvency situation arises.

2. ACCESS TO THE INSOLVENCY PROCESS

The issue

Access by debtors to Canada's insolvency system is increasingly difficult, because legitimate low-income debtors may find themselves unable to bear the costs associated with entering into bankruptcy.

Background

The administration of assets in an insolvency system is the job of trustees, who are generally either independent or associated with accounting firms. The *BIA* states that trustees are entitled to fees for services rendered. These fees must be paid from the pool of funds generated by the estate. Depending on the type of administration involved in the specific case, the fees are determined by the creditors or by a tariff that is based on a percentage of the total value of realized assets.

Trustees have no obligation to act as trustees for any assets. But once they have agreed to handle a matter, they must carry out their duties until they are discharged or another trustee is appointed in their place. For this reason, if a trustee believes it may be difficult to collect the fees, the trustee may be inclined to require an advance or security as a condition for taking on the matter. Such an approach is a barrier to access for low-income debtors who wish to avail themselves of the *BIA*.

Insolvent debtors do not earn enough income to cover all their debts. For most, their income is barely sufficient to cover their living expenses. Approximately 80 percent of consumer bankrupts in 2001 had no surplus income — that is, they were unable to pay a portion of their monthly income into the bankruptcy estate for the benefit of the creditors as a whole. The situation is even more critical when the income does not cover basic family needs. Debtors in these situations may not have access to the insolvency process because they are unable to pay the administrative fees. To overcome this problem the OSB has established the Bankruptcy Assistance Program, based on voluntary participation by trustees, who have agreed to provide services at no charge to debtors who are unable to afford the services of a trustee.

In addition, the assets available for realization and distribution are determined by the Act, which expressly states that some of the debtor's assets cannot be included in the estate distributable to his or her creditors. This includes property exempt from seizure under provincial law. The trustee does not have control over that property and cannot seize it. The creditors cannot benefit from the sale of that property and its value cannot be taken into account in determining the trustee's fees. As a result any reduction in the pool of seizable assets has a direct impact on the amounts that can be generated in the estate and consequently on the money available for administration costs.

Legislation, administrative measures and court decisions have all contributed to reducing the size of this pool over the past 10 years. GST credit payments and the credit for heating allowance are examples of payments that cannot (at least to some extent) be included in the total value of assets for the purposes of determining fees. Provincial legislatures have increased the value of property exempt from seizure. In addition, some courts have rendered decisions preventing trustees from collecting certain amounts from discharged debtors even though the debtors had initially agreed to pay these amounts, thereby reducing the trustees' fees by an equivalent amount.

At the present time, approximately 50 percent of the files do not generate sufficient funds to warrant any distribution to creditors. Furthermore, in 13 percent of these cases, there is less than $1000 in receipts, which is generally insufficient to cover administrative costs. This creates an additional obstacle to efforts to ensure the insolvency process remains accessible.

Considerations

This situation is worrisome because it could ultimately bar access to all but those who can pay the administration fees. Paradoxically, for the neediest of persons — those for whom the insolvency process is a veritable lifeline — purely monetary considerations could constitute a substantial obstacle to access. Moreover, this situation tends to discourage trustees from participating in the Bankruptcy Assistance Program, further limiting low-income debtors' access to the insolvency system. In fact, trustee participation in the Bankruptcy Assistance Program has observably declined in parts of the country.

In this context, should the concept of universal access to bankruptcy services be redefined with new measures taken to ensure access, or should access cease to be seen as a right?

3. THE DEBTOR COMPLIANCE PROGRAM

The issue

An effective program to ensure debtor compliance with the Act is essential to eliminate abuse and maintain the public's trust. The rising caseload, combined with the increasing complexity of cases and scarcity of resources, is undermining the effectiveness of these programs.

Background

Participants at national forums on insolvency held in 1999 indicated that debtor compliance issues were a major concern for them. The OSB uses a number of methods for uncovering and eliminating abuse and works closely with the Royal Canadian Mounted Police (RCMP), to which it entrusts the task of conducting criminal investigations. Clearly, however, the caseload increase is reducing the number of files that can be sampled for detection, thereby increasing the risk of unchecked abuses.

The RCMP's availability and capacity for dealing with investigations originating with the OSB are increasingly constrained by the reduction in police resources allocated to economic crimes. This phenomenon has reduced the number of cases entrusted to the RCMP over the years and is unduly prolonging properly assigned cases.

Allocation of police resources to bankruptcy investigations is increasingly sporadic. Persons assigned to insolvency cases are regularly and suddenly reassigned to other unrelated duties, causing excessive delays and hampering the evidence gathering process.

Considerations

Insufficient allocation of resources to investigations can cause many people to believe that offences can be committed with impunity and perpetuates the idea that a person can plan a fraudulent bankruptcy without incurring meaningful risks.

In addition, the economic fraud investigation mechanism is cumbersome, complex, long and costly. When an investigation is launched, people must be interviewed, public funds are used, joint meetings between the OSB and the RCMP are held, and Crown prosecutors must be assigned to the case. The complexity of these investigations, using multidisciplinary resources, requires a high degree of cooperation between various authorities. As such, the offences part of the *BIA* could be modernized and also reviewed to determine if some of these offences would be better addressed through the use of civil and/or administrative remedies rather than having to resort to criminal proceedings.

Again, the absence of an effective compliance program could quickly give rise to a perception that a person can plan a fraudulent bankruptcy without running any serious risk. Such a situation can quickly erode the confidence of lenders and investors, which could increase the cost of credit and reduce investments, affecting businesses and consumers alike.

4. REGULATORY SUPERVISION: REORGANIZATIONS UNDER THE *CCAA*

The issue

Unlike other insolvency-related legislation, the *CCAA* is not subject to any administrative supervision process. Without this supervisory authority, it is practically impossible to assess procedures under the *CCAA* or to verify whether services are being performed properly. It is also very difficult to measure the effectiveness of the reorganization schemes or to verify whether they are being applied and administered consistently.

Background

Canada has two statutes governing reorganizations of corporations — the *BIA* and the *CCAA*. This contrasts with the United States, where all reorganizations are covered under the *Bankruptcy Code*.

Many large businesses experiencing serious financial problems opt for the *CCAA* regime. Yet there is no simple way to determine which companies use the *CCAA* in a given year, nor to ascertain their profiles or how successful their reorganization processes were. This is because there is no centralized public record of *CCAA* reorganizations.

The lack of information about complaints against one or more parties involved in the *CCAA* process creates another constraint. It is practically impossible to do a proper analysis of the main grievances. If such an analysis were performed, preventive measures could be implemented, thereby increasing confidence in results under the *CCAA* and in the parties involved.

Since 1997, the *CCAA* has required a monitor to be appointed to monitor the affairs and finances of the company during the reorganization period, in accordance with the order of the court. Monitors are not subject to any qualification requirements or rules of professional conduct. Many stakeholders have expressed concerns about this, noting the numerous potential conflicts of interests they might face, especially if they are acting in various other capacities for the debtor company.

Considerations

Since there is no supervisory agency and with records being scattered among the various courts in which the individual cases are commenced, there is no way to ascertain the results of proceedings under the *CCAA* regime. For all intents and purposes, it is impossible to measure the impact of the *CCAA's* use on the Canadian economy. Although results can be obtained for a specific situation, there is no way to assess the performance of the *CCAA* overall. Ultimately, the lack of a supervisory process could undermine the trust of investors and lenders, causing them to consider withdrawing their financial backing when faced with proceedings under the *CCAA*.

Given the social and economic importance of *CCAA* reorganizations and the burgeoning number of *CCAA* proceedings over the past decade, the implementation of a supervisory regime may be worthy of consideration. The regime could:

- establish a national and public registry;
- include mechanisms to handle complaints;
- provide the power to intervene in court proceedings under the *CCAA*, much like the power under subsection 5(4) of the *BIA*; and
- state that only holders of a trustee licence may be monitors.

These characteristics would not unduly constrain the flexibility required in large company reorganizations. They would make the process more transparent and ensure that creditors and other stakeholders would have a grievance resolution mechanism that is less onerous than court litigation.

5. REGULATORY SUPERVISION: COMPLIANCE OF RECEIVERSHIPS

The issue

Part XI of the *BIA*, which governs receiverships, has not been effective. It has not been used as intended in many areas of the country.

Background

Part XI of the *BIA* governs a secured creditor's realization of a security when the creditor or its agent, called a "receiver," takes possession of all or substantially all of the assets of a business to realize them for the benefit of the secured creditor. Among other things, Part XI provides for a system of notices to be sent to creditors, the keeping of a public record, and for receivers to render accounts and act with care when selling the debtor's assets.

Common law courts have interpreted Part XI restrictively and have even suggested a tempered approach in implementing its provisions. The prevailing opinion is that Part XI does not apply in Quebec because there is no corresponding concept in Quebec civil law to the concept of receiverships.

The definition of "receiver" in subsection 243(2) of the *BIA* completely excludes numerous situations akin to receiverships from Part XI. For example, it excludes lessors who cause a merchant's property to be sold following a default in payment of rent.

Considerations

Many believe that the protection offered by Part XI of the *BIA* is illusory. Creditors are more interested in protecting their claims and maximizing their recovery and the penalties for those who do not comply with the provisions are weak.

Some say that the mechanisms in Part XI are cumbersome and unhelpful in many situations where the value of the assets is relatively low. They would like to be exempt from Part XI, or at least have a simplified procedure applied to their circumstances.

Others believe that provincial legislation governing security on property adequately protects debtors and unsecured creditors against abusive realizations, and that Part XI makes little or no contribution in this regard.

6. FUNDING OF OPERATIONS

The issue

In 1997, the OSB became a Special Operating Agency for bankruptcy system users. This enabled it to benefit from greater administrative flexibility and requires, among other things, that it operate on a cost-recovery basis. Currently, the OSB depends solely on income generated by its operations to carry out its statutory mandate. Yet certain statutory and administrative constraints that it must deal with seem inequitable.

Background

One of the challenges facing the OSB is to find the best way to ensure compliance with the *BIA* while dealing with budgetary limitations. Since becoming a Special Operating Agency, the OSB carries out its operations with greater transparency, is more accountable for its results, and is more committed to responding to clients' concerns. The number of insolvencies has been rising every year, with caseloads increasing at the same rate, and as a result the risks of non-compliance or fraud by debtors or trustees are also increasing.

The OSB's approach to carrying out its mandate has changed somewhat over the last few years. It now accords less importance to following up on individual files and more importance to supervising trustees and debtors. These compliance activities are currently funded through a variety of fees: filing fees, levies on dividends payable to the creditors, licence fees, and fees for searching the public record.

The insolvency process is under significant pressure. Just as the rise in insolvencies is increasing the workload, the OSB must make sure that the various compliance programs are properly run, even though increased resources must be devoted to process the growing volume of insolvencies. To deal with this situation, it is crucial to find new bases of revenue so that the OSB can carry out its mandate under the Act effectively.

Moreover, revenue inflow is not properly matched with work effort. A significant output of work is required in the year following the opening of an insolvency file, but most of the fees, the majority of which are levies on dividends, are only collected in the second or third year. This puts pressure on the OSB to increase registration fees so that it can meet these requirements and better match revenue inflow with workload.

Considerations

The current fee structure of the OSB is consistent with the fairness principle, which holds that all funding structures should be based on the proposition that those who benefit from a service should support the associated costs. But some stakeholders believe that the user-pay principle should not be the sole basis for allocating fee increases. They argue that the entire Canadian public benefits from an effective and just insolvency system that can be trusted. Thus, in their view, taxpayers should absorb a part of the OSB's operating costs, notably in the area of compliance.

It is tempting to increase filing fees. Unlike levies, these filing fees are collected at the very beginning of the bankruptcy process; they constitute more predictable inflows, and few external factors can distort budget forecasts. Any increase in filing fees, however, aggravates the access problem for debtors with limited financial resources.

Under the current Act, the Superintendent administers an account for unclaimed dividends and undistributed funds. The amount accumulated in that account stands at $7 120 000 as of January 2002. In a cost-recovery system, it would seem fair to allow these amounts to be reinvested in the process and to help reduce the costs for all interested parties. There are some benefits to this approach, notably that it would be relatively easy to administer and would generate additional revenues. An amendment to the Act providing for a limitation period of perhaps two years would be needed. After that period, unclaimed amounts could be credited to the OSB.

Cross financing would be an alternative to meet the requirement to reduce the financial pressures on the OSB. For example, the filing fee for receiverships could be substantially increased so that it is comparable to the filing fee for an ordinary bankruptcy. The surplus from the receivership filing fees could fund other insolvency procedures or services. Currently, costs from receiverships are recovered in full and under the current funding framework it would be difficult to accept a situation where surpluses were allocated to other services. Lessening this restriction would be justified, since it is imperative to keep consumer filing fees as low as possible so as not to reduce access to the insolvency process.

Another avenue that is being considered is to amend the Act to allow investigation costs to be recovered in files where the conduct of a trustee is at issue.

The benefit of these alternatives would be to reduce the pressure on the OSB to increase filing fees.

7. ADVANTAGES OF NEW TECHNOLOGY

The issue

Since bankruptcy and insolvency processes are primarily legal, there are several provisions in the *BIA* that need to be changed to fully enable the use of electronic transactions.

Background

The OSB has committed itself to implementing an electronic system that can perform tasks currently carried out on paper. Practically every service is involved: transmitting information or documents, communications, cash and other transactions, and filing and registering insolvency proceedings. This is in keeping with the changes being experienced by banks, courts and many other institutions.

There are many advantages to electronic transactions: they are conducted more quickly, users benefit from lower costs, and the increase in insolvency proceedings becomes easier to handle. New information exchange and processing systems will also increase the OSB's capacity to analyse compliance programs and policies. Such a change would appear to offer benefits to both users and the OSB. This type of program may not be possible without clarifying the *BIA* specifically to allow electronic transactions.

Many stakeholders are already convinced of the enormous potential that e-commerce offers and hope to put it to good use in the insolvency field. Close to 80 percent of the OSB's services are already available electronically and the OSB projects that all of these services will be available electronically by 2004.

Considerations

Some provisions of the *BIA* could be amended to provide more clearly for electronic transactions. The amendments would enable trustees, creditors, courts and all interested parties to take full advantage of technological innovations in their legal dealings with each other. Greater permissiveness would generally improve the processing of transactions and reduce system costs.

IV. COMMERCIAL INSOLVENCY ISSUES

Over the past few years, Industry Canada has been reviewing Canada's insolvency legislation as it relates to commercial issues. This process culminated in a series of public consultation meetings held in the fall of 2001. Discussion papers issued by Industry Canada were used to stimulate debate on a dozen topics. Other issues were raised by stakeholders before, during and after these meetings.

This section provides the Committee with a brief overview of 14 issues, the views of the different stakeholders, and the ideas that emerged from the consultations. During the consultations, meetings were held across Canada that were attended by over 200 interested stakeholders. Industry Canada distributed three discussion papers prior to the consultations and has received comments on the issues raised in the papers, in both written submissions and in the consultations themselves. Small and large businesses, academics, lawyers, judges, financial institutions, the credit industry, labour, and various federal and provincial government agencies all contributed.

The issues can be broadly classified in three groups, where:

- there are contentious differences among stakeholder groups about what policy should be followed. These include wage and pension protection, debtor-in-possession financing, unpaid supplier rights, and the adoption of the UNCITRAL Model Law on Cross-Border Insolvencies.

- there are significant differences among stakeholders, but the differences do not appear to be insurmountable and can likely be resolved to general satisfaction through technical amendments. These include contractual rights, integration of the *BIA* and the *CCAA*, directors' liability, sanctions for director and officer conduct detrimental to creditors, and transfers at undervalue and preferences.

- there is general support for a particular course of action. This includes proposals that comprise securities firm bankruptcies, the *Winding-up and Restructuring Act*, financial market issues, and trustee liability for successor employer obligations and pension claims.

1. WAGE-EARNER PROTECTION

The issue

The degree to which wage and pension income is protected in insolvency proceedings is of concern.

Background

The *BIA* provides a measure of protection to wage earners. Wage claims up to $2000 are a preferred claim, ranking ahead of ordinary creditors' claims in a bankruptcy, but behind secured creditors' claims and some Crown claims (Appendix B describes the priority of claims). This level of protection was provided by amendments to the *BIA* enacted in 1992, which raised the amount of wages protected from the $500 provided in the 1949 *Bankruptcy Act*.

Wage-earner protection in bankruptcy is a long-standing issue in Canada. It has been considered on numerous occasions since 1970, and the 1992 amendments have by no means laid the issue to rest. Several models for protection have been considered in these previous reform efforts, all of which would have provided stronger protection than is now available. They included super-priority protection for wages, ranking wage claims ahead even of secured claims, and compensation of wages out of a fund financed by a tax on employers or employees, or out of general revenues. A variation of funded protection was to provide protection to wage earners through the Employment Insurance Program.

Super-priority protection has been considered in all of the reform efforts to date. Super-priority provisions were proposed in government bankruptcy bills introduced in 1975 and 1984.

A wage protection fund was proposed in Bill C-22, as it was introduced in 1991. Wage claims up to $2000 would have been protected in bankruptcies and receiverships. The fund provisions were withdrawn from the Bill before its enactment in 1992. Fund protection was endorsed by the Senate Committee in 1975 and 1980, the Landry Committee in 1981, the Colter Committee in 1986 and the de Grandpré Committee in 1989.[7]

Protection under the Employment Insurance Program was considered before the development of the Bill C-22 reforms, and again in the discussions leading up to the 1997 amendments to the *BIA*. No proposal went forward.

7. The Committee on Wage Protection in Matters of Bankruptcy and Insolvency, chaired by Raymond Landry, was established by the Minister of Consumer and Corporate Affairs in 1980 to advise the government on how wage protection could best be achieved. The Advisory Committee on Bankruptcy and Insolvency, chaired by Gary Colter, was set up by the Minister of Consumer and Corporate Affairs in 1985 to examine the bankruptcy system and recommend changes to modernize it. Jean de Grandpré chaired the Advisory Council on Adjustment to the Free Trade Agreement.

Considerations

It is generally accepted that employees are vulnerable creditors. They usually lack the information to assess the risk that their employer will go bankrupt, and have limited bargaining power to protect themselves. Distributional questions of fairness are involved, because any protection for wage earners must be paid for by the other creditors, employers or taxpayers generally, depending on the form of protection. Wage protection measures may also affect economic activity and efficiency, because those who bear the costs of protecting wage earners can be expected to adjust their behaviour to minimize those costs.

Super-priority would provide stronger protection than presently exists by elevating the employee ahead of at least some other creditors. However, it still provides neither certain nor necessarily prompt protection. Super-priorities may also affect credit availability by imposing higher risks on secured creditors, especially where the financing involves labour intensive industries. These shortcomings have previously been noted by the Standing Senate Committee on Banking, Trade and Commerce.

A fund would provide certain protection. A major issue for fund protection has been the cost. The proposed 1991 scheme was estimated to cost about $60 million. A federal government study carried out in 2000 indicated that wage claims under a super-priority system are likely to be in the $15 million to $25 million range. This assumes no change in behaviour as a result of the fund. Administrative costs would have to be added to those projections. Another issue is whether such a cost should be imposed on employers who would not go bankrupt, such as governments, municipalities, universities, schools and hospitals.

Consultations

In consultations held with insolvency law stakeholders in September and October 2001, the majority viewed wage earners as vulnerable creditors who need some form of statutory protection. Current protection was generally thought to be insufficient. Still, it was noted that wages are often paid by the employer's bank; when going concern sales of a bankrupt enterprise are arranged, the successor employer takes on responsibility for wages.

Of the possible measures to improve protection, a super-priority was preferred. This would raise the priority for wage claims over the claims of secured creditors. Stakeholders advised that strict limitations be imposed, including a dollar cap, a short protection period (one pay period was suggested), and limiting coverage to wages only (not vacation, severance or termination pay). It was also suggested that perhaps the super-priority could be made to apply only to a business's working capital assets.

Some problems were noted, even with limited super-priority measures. Lenders said that super-priority would affect their margin calculations and reduce credit availability.

Having the *BIA* recognize provincial super-priorities was seen as a variant of the super-priority approach. Some concern was expressed about the possible administrative difficulties that would be encountered under this model, which would provide for different levels of protection in different provinces. On the other hand, some favoured this approach of adopting super-priorities with which lenders are comfortable now.

There was some support for the wage protection fund option, though less than for a super-priority. On the positive side, stakeholders noted the ability of a fund to provide certain and prompt protection (although the experience of Ontario and to a lesser extent Manitoba with their funds has cast doubt on the promptness of payment under a fund). On the negative side, it was said that funds would generate strategic behaviour, raising its costs considerably above what the current volume of wage claims in bankruptcy would suggest. In particular, it was noted that banks would stop voluntarily funding wage claims. Maximum use would then be made of funds because wage earners, encouraged by employers, would always take advantage of them. Those directly involved — wage earners, employers and creditors — would have no incentive to keep costs down. Concern was also expressed about the added bureaucracy that a fund would require and about making employers contribute who would not likely go bankrupt.

In the consultations, Employment Insurance-related funding was supported by labour ministry officials from several provinces, in particular the option that would see the Employment Insurance Program waive the standard two-week waiting period in the case of an employee from a bankrupt business. In a separate process, provincial members of the Canadian Association of Administrators of Labour Legislation support reform and proposed a model that would see the Employment Insurance fund pay up to $2000 in unpaid wages resulting from bankruptcy. Employment Insurance would then recover those funds from any funds collected by the Canada Customs and Revenue Agency from its super-priority claim. This could be coupled with the waiver of the two-week waiting period. This type of funding would provide certain and relatively prompt protection. However, there are concerns that it may not be consistent with the intentions of the *Employment Insurance Act*.

2. PENSION PROTECTION

The issue

There are concerns about whether the existing protection for unpaid contributions and unfunded liabilities of pension plans is adequate and, if not, how it should be enhanced.

Background

The *BIA* provides no special protection for unpaid contributions to pension plans. Priorities are provided under federal and provincial pension legislation, although it is uncertain whether the provincial priorities would be recognized in bankruptcies. Ontario is the only province that provides funded protection for pension claims.

Pension protection has been less of an issue in previous bankruptcy reform efforts than wage protection. Nevertheless bankruptcy bills tabled in the 1970s and 1980s would have given priority for up to $500 in pension claims and the Landry, Colter and de Grandpré committees all recommended that pension claims be covered by the funds they proposed.

Considerations

Many of the same considerations apply as with wages. Pensioners are vulnerable and lack the information to assess risks properly and to protect themselves. Super-priorities covering pension claims would increase protection, but could also affect credit availability. A fund would provide more certain protection, but the financing costs could be significant.

Consultations

Some regarded the current protection as insufficient, although there was less concern about pension claims than wage claims. Claims for unfunded liabilities were said to be a more serious problem than claims for unremitted periodic contributions. Unfunded liabilities could be identified by an actuarial study determining that a plan was underfunded, or by an improvement in plan benefits negotiated between an employer and plan members that would put a plan in an underfunded situation temporarily. It was suggested that protecting unfunded liabilities caused by negotiated plan improvements would be unfair, in that it would impose added risk on an employer's creditors. Defined-benefit plans were said to be a much more serious problem than defined-contribution plans, since with benefit plans, a deterioration in plan investments may reduce plan assets below the level needed to cover the fixed benefit obligations, triggering unfunded liabilities. It was suggested that improved protection for pension plan claims would be discriminatory, because most of the benefits would be reaped by defined-benefit plan members.

A super-priority was the most favoured method of improving protection for pension plan claims. As with wages, however, the support was subject to strict limitations, including a dollar cap, coverage only for periodic contributions (not unfunded liabilities), coverage for one period in contributions only, and priority against working capital only. Lenders indicated that super-priorities would affect credit availability, especially if unfunded liabilities are covered.

Protecting pension plan claims through a fund received less support than did a super-priority. Provincial governments were not enthusiastic about providing fund protection, given previous experiences in Manitoba and Ontario. There also was some concern about covering unfunded liabilities. These could impose a potentially large financing burden on taxpayers.

3. DEBTOR-IN-POSSESSION FINANCING

The issue

Stakeholders are concerned about whether new financing for a reorganizing company should be entitled to rank ahead of existing creditors, when that financing is necessary to the restructuring of the company.

Background

Debtor-in-possession financing, also referred to as DIP financing, is a financial vehicle used to assist insolvent businesses. A business that seeks to reorganize, whether under the *CCAA* or the *BIA*, typically requires cash. Usually these businesses would already be heavily financed; otherwise their usual financing sources would be available to them. Lending to such a business on normal terms is risky, given the existing financial hardship and the lack of available security.

In DIP financing a new lender provides an injection of cash, but in exchange for doing so may jump ahead of other secured creditors. This way, if the reorganization is unsuccessful, the new lender is protected at the expense of other creditors. The benefit to the other creditors is that if the reorganization is successful, they may recover more of what is owed to them than if the corporation went bankrupt. If there was no infusion of cash, the business would likely fail completely.

Neither the *BIA* or the *CCAA* has any provisions that deal with DIP financing. It is an American creation, which Canadian judges have authorized in *CCAA* cases under what is referred to as their “inherent jurisdiction.”

Considerations

Through DIP financing, businesses that would otherwise be liquidated in bankruptcy have the opportunity to continue. If successful, jobs are saved, creditors receive a greater return and a profitable enterprise contributes to economic growth. The easier the access to such financing, the more businesses have the opportunity for recovery.

On the other hand, reorganizations that are not successful end up as bankruptcies. In these cases, a creditor who has had his or her security displaced by the new lender runs the risk of greater loss than the creditor may have experienced if the company had gone bankrupt at the earlier opportunity. Giving creditors more control over whether they wish to exercise their secured rights or participate in the reorganization would certainly improve fairness, but may make DIP financing impractical. Greater creditor control allows market forces to operate freely as the terms between the original borrower and lender are respected.

Concern also exists that an insolvent company, which may have both financial and managerial difficulties, may do no better with new financing and simply result in greater loss. This concern is heightened by the instability of the company. If the company has only a token net worth at that time, the management of the company are gambling with someone else's money, particularly those whose security was lost or diminished.

Consultations

A majority of stakeholders felt that DIP financing should not be imposed on creditors without further defining for the courts the circumstances in which it is warranted. This is not what the present circumstance is, however, and there is a strong element of the public who support leaving the *CCAA* as it is. Much work needs to be done to fashion a system that satisfies the concerns of all parties.

While the merit of saving companies was acknowledged, and while it was accepted that DIP financing may be fundamental to doing so, many of those commenting held the view that it was inappropriate to be required to take on added risk without any choice in the matter.

Much of this view was based on two fundamental points. First, the success rate for reorganizations is unknown, because *CCAA* proceedings are not reported anywhere. In the absence of any idea about how often a reorganization benefits the existing creditors versus resulting in later failure, it is hard to measure the value of DIP financing. Second, DIP financing emanates from the U.S. system, where there are some fundamental differences both legally and economically that help to justify its application.

Those challenging DIP financing noted that generally businesses in the United States are not as heavily financed as those in Canada. As a result, when DIP financing is required there may be room to add a creditor without causing severe risk to other creditors' security. This economic situation is reflected in the U.S. legislation, which requires that U.S. businesses have that financial cushion and that the financing be shown to benefit the existing creditors. The comparable Canadian provisions do not require the same protection to creditors and might best be described as using a "net benefit" assessment. In a Canadian case, a judge may evaluate the benefit and risks and based upon that determine whether the financing is appropriate, without having to ensure any protection for the existing creditors.

There is the added problem that DIP financing can cause some uncertainty in the financial community. Since a creditor is unsure of whether it may be drawn into a situation involving DIP financing, creditors may be more likely to step in earlier and seize the security when a business experiences difficulty, rather than trying to support the business in troubled times. Further, it is not clear whether the added risk could cause an increase in the cost of borrowing or a restriction of credit availability.

The proponents of leaving the DIP rules as they are felt that because the tool is being used more frequently, judges are becoming more aware of the intricacies and are building case law to guide debates on these issues. The proponents' view is that much of this is now quite standardized and relatively predictable. It is also their concern that any effort to exercise further control over DIP financing will ultimately result in more limited access and in more businesses declaring bankruptcy rather than attempting reorganization.

In an effort to make DIP financing easier to use with identifiable expectations and effects, the Insolvency Institute of Canada has submitted several recommendations to Industry Canada. Most notably they recommend that DIP financing be entrenched in legislation, along with several principles to be used by the courts in determining when it should be approved.

4. UNPAID SUPPLIERS' RIGHTS

The issue

Stakeholders have raised concerns about the effectiveness of existing statutory protection provided to unpaid suppliers.

Background

Before 1992, there was no protection in the *BIA* for unpaid suppliers. In that year the *BIA* was amended to give suppliers rights to repossess goods delivered just before bankruptcy or receivership if payment had not been received. Subsection 81.1(1) of the *BIA* lays out several conditions to the application of this section, requiring the goods to be identifiable, in the same state as they were on delivery and not to have been resold at arm's length.

A supplier may not repossess goods from a debtor who is in the process of reorganizing under the *BIA*. Should the debtor later become bankrupt, the supplier may then repossess those goods delivered just before the reorganization. The supplier's right to repossess takes priority over all claims except that of a bona fide buyer.

While intended to offer protection to suppliers, this protection has been criticized as ineffective and inefficient by many stakeholders. It also has gaps in protection. For example, a provider of a service that cannot be repossessed has no protection, while one who provides tangible goods is protected. Nor does protection exist for services in a reorganization under either the *BIA* or *CCAA*.

Some protection does exist through various provincial statutes and the principle of a possessory lien in common law, though these are not broad enough to cover all suppliers or circumstances.

Considerations

Suppliers, particularly small ones or those in a market with very few purchasers, may not be in a position to demand security for the transaction. This may be a result of the bargaining power between the two parties, the cost of having to obtain security for goods that turn over quickly, and the financial costs associated with obtaining security. In any event, most suppliers of goods do not have security for payment and rely on the purchaser to make payment according to the terms of the contract.

In addition to helping suppliers secure payment or recovery, the present protection was also seen as help for troubled businesses. Because suppliers are able to recover either the goods or payment, there is less reason for them to back away from troubled businesses and stop supply. The intention was that this would help businesses through financial distress and encourage recovery. But this comes at a price in the event of failure. If the business fails and the supplier repossesses, there are fewer assets available to other creditors, so ultimately those other creditors bear the cost of the protection. In theory this could affect credit markets as other creditors seek to protect themselves against increased losses.

Furthermore, there is the question of granting a supplier protection that did not exist in the contract, in effect granting the supplier greater protection than he or she bargained for.

Consultations

This issue emerged as one of the most divisive in the various consultations.

Suppliers, who were to benefit most from the legislation, indicated they have difficulty in applying the protection in its present form. They would prefer improved protection, but certainly do not want anything less than the existing protection.

Their concern is not solely with the legislation. Courts have defined the limits on the repossession rights very narrowly. For example, if goods are boxed individually and then put in a larger carton of a dozen for shipping, the court may find that once one box has been removed from the larger carton then the goods are no longer in the same state as when they were sold, preventing the repossession of the other eleven items. For that type of reason the existing legislation is hard to apply. Suppliers would like to see these difficulties ironed out, perhaps through legislation that gives more specific guidance to courts.

The suppliers also support an amendment to the timing provisions. The present 30-day repossession period is only of benefit if the supplier has knowledge of the bankruptcy within sufficient time to exercise his or her right. Conceivably a debtor could enter into bankruptcy on day 27 and the creditor may not be aware of it within the 30-day period, eliminating any possibility of repossession. Hence suppliers supported the idea of allowing them 15 or 30 days after bankruptcy to repossess goods delivered within 30 days before bankruptcy. The suppliers' reasoning is that this would ensure them the opportunity to exercise their right. Criticism of this proposal included the potential delay in liquidating the assets while such claims are worked out and the fact that it may affect credit availability.

Another proposal received from supplier groups was that they could be offered the first right option to purchase the goods back from the bankrupt. This has the potential to increase the recovery by all creditors, while giving the supplier in question an opportunity to recover full value by reselling the goods to another buyer. Suppliers of goods of a more exclusive nature, or with a controlled distribution network, would also retain control over their product. Again, the issue of possible delays in liquidating the assets was raised.

There was very strong opposition to these arguments from other groups, particularly lawyers and trustees, for reasons of principle and practicality. The whole premise of any enhanced right for suppliers was attacked, largely on the ground that they have options available through a contract to obtain security if that is what they seek. It was suggested that there is no fundamental reason to offer enhanced protection.

Further criticism was directed at the present scheme in particular. There were questions about the efficiency of the system. Many insolvency professionals suggested that it is infrequently used, in part because it is largely ineffective as a result of court interpretations. From an administrative perspective, they claimed it can be burdensome and awkward to determine who supplied which goods at what times.

The issue of incorporating these types of protection into reorganizations was also raised. Suppliers want to be certain of payment in these situations; it was argued, however, that this would make reorganizations more difficult.

Other protections that were discussed included the possibility of increasing the liability of directors for "stocking up." The debtor may order larger than necessary quantities of goods from a supplier to whom the debtor has given no personal guarantee; then upon bankruptcy the excess goods would (at least in part) go to satisfy the creditor to whom a personal guarantee is owed, thereby reducing the personal liability of the director.

While creditors liked the idea of additional protection, all groups acknowledged that it would also be difficult and costly to enforce and would pose problems in defining what would constitute stocking up. It was also suggested that directors already face enough personal exposure.

5. UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCIES

The issue

Canada must decide whether to adopt the United Nations Working Group on Insolvency Law's Model Law on Cross-Border Insolvencies in place of the existing Part XIII of the *BIA*.

Background

The current rules on international insolvencies are contained in Part XIII of the *BIA* and section 18.6 of the *CCAA*. Part XIII of the *BIA* was adopted in 1997 in response to the increasing globalization of economic activity and the increase in insolvencies with an international dimension.

At the same time that Part XIII was being developed in Canada, the United Nations Working Group on Insolvency Law developed its Model Law on Cross-Border Insolvencies. The United Nations Commission on International Trade Law (UNCITRAL) adopted the model law in May 1997, about a month after the *BIA* amendments incorporating Part XIII were enacted in Canada. Canada was an active participant in the Working Group and supported UNCITRAL's adoption of the model law.

The model law is a legislative text that UNCITRAL recommends countries adopt as part of their domestic insolvency law. To date, the model law has been adopted only by South Africa, Mexico, Eritrea, and within Yugoslavia, Montenegro. Japan has recently passed legislation that parallels the model law and a current bill in the U.S. Congress to amend the U.S. *Bankruptcy Code* would include adoption of the model law. The basic features of the model law are reflected in Canada's existing Part XIII.

Considerations

Adoption of the model law would help to further international harmonization in the treatment of international insolvencies. Given that interpretation of the rules governing international insolvencies would be more uniform, the administration of international insolvencies would be helped. The tasks of foreign representatives trying to administer insolvencies of debtors with assets in Canada would be made easier.

One issue is whether Canada should include a reciprocity provision if it adopts the model law. A reciprocity provision would stipulate that foreign representatives could only benefit from Canadian model law provisions if their country also has adopted the model law. Canada's adoption of such a provision would ensure that the benefit of the model law would be available to foreign representatives if Canadian creditors have similar rights in those foreign jurisdictions.

Adoption of the model law would give foreign representatives more rights and powers than they have now under Part XIII to take possession of a debtor's assets and distribute them. Proceedings would still be subject to Canadian insolvency rules and Canadian courts would have jurisdiction to require that Canadian creditors and other interested parties are adequately protected. The pre-eminence given in the model law to domestic proceedings that are concurrent with foreign proceedings would help to ensure that Canadian participants would not be prejudiced. Given the formalized status of "foreign main proceedings," there may be an impact on decisions in Canada in an effort to give effect to the foreign decision. Though the impact would not be contrary to Canadian law, it may be that a court will take a course of action different from what it would take in the absence of the model law.

At this time, it is difficult to measure the extent to which these provisions could result in outcomes that are different from what they would be under Part XIII. Any impact might be minimized by the use of the provisions that accommodate the domestic laws.

Consultations

There were significant differences on this issue. No consensus could be obtained on whether the UNCITRAL Model Law on Cross-Border Insolvencies should be adopted or Part XIII of the *BIA* should be retained. Although a modest majority would support adoption, there appears to be no middle ground to satisfy those with concerns.

The option of adopting the model law received some support for the effective way it provides for dealing with globalization and the attendant need for coordination. It was said that in view of Canadian participation in the development of the model law, it would be contradictory not to adopt it. Some said that Canada needs to adopt the model law for commercial reasons and that there is a fundamental interest in having international bankruptcies administrated evenly.

Most did not express any concern about the possibility that adopting the model law could reduce the number of cases heard in Canada. Laidlaw was cited as a case where Canadian creditors of that Canadian company were forced to go to U.S. courts, a result that would not likely happen under the model law. However, others were concerned that the United States would dominate any proceedings. It was said that the model law protects local creditors, adopts local rules and enables creditors to start local proceedings. The majority said that if the United States adopts it, Canada will face pressure to adopt it.

A number of stakeholders thought that Canada should adopt the model law, but with a reciprocity clause offering the benefits only to creditors from other countries that had adopted the model law. Others expressed the opinion that Canada should not adopt the model law as is, but should adopt it with some modifications (as the model law allows us to do). Others were concerned about adding only some model law features to Part XIII, instead of adopting the entire model law.

GROUP 2

6. CONTRACTUAL RIGHTS

The issue

Another consideration is the extent to which insolvency law should intervene in private contracts for the purpose of ensuring fair distribution or maximization of value in an insolvency. For example, should a creditor who holds security in exchange for a mortgage be restrained from taking that security if the delay might benefit other creditors?

Background

Contracts are fundamental to business, with the terms negotiated in good faith and reflecting the risks. There are concerns about the extent to which they should be interfered with and in what circumstances. This is particularly a concern in the field of intellectual property, where innovation has outpaced the modernization of the *BIA* and *CCAA*. Specific concerns include whether:

- secured creditors should be temporarily stayed from enforcing their rights in bankruptcy;
- the *BIA* requires rules governing leases; and
- the existing intellectual property rights reflect the competing interests of various parties.

The 1949 *Bankruptcy Act* imposed few restraints on completed contracts, other than preventing action by an unsecured creditor and granting the court jurisdiction to limit action by a secured creditor. It also explicitly recognized provincial legislation related to property leases. After a reorganization began, the 1992 amendments prevented secured creditors from exercising their security, as well as preventing a termination of a lease, licensing agreement or public utilities due to default. Despite these limits on creditors, debtors were empowered to disclaim leases on real property.

Considerations

The paramount consideration in dealing with contractual rights is efficiency. Interventions in contractual rights upset contractors' expectations, reduce predictability and certainty in contracting and increase risks. Any intrusion should be assessed in terms of the overall benefit achieved when compared with the harm that may be caused by the intervention.

There are occasions where the continuation of a contract can be advantageous in a broad sense. One example would be to allow some time for a trustee to use leased premises while the assets are evaluated and liquidated, rather than forcing an immediate sale under forced conditions or the movement of goods on the premises. Although an immediate termination of the lease may be preferable for the landlord, a fire sale under those circumstances, or the additional cost of moving the assets, could reduce the amount recovered. In turn, this would negatively affect most creditors.

Similarly where software is used under licence, it is often integral to a business and may even be custom designed. If the licensor goes bankrupt and the licence terminates, the company using the software may be put at risk or face considerable costs. The reverse is equally true: if the licensee is facing bankruptcy and a buyer for the business can be found, the sale may be dependent on the continuation of the licence agreement for the software. But what if the licence is non-transferable, or the licensor does not approve the new user? Then the whole deal may collapse, to the detriment of other creditors.

Any legislative intervention would effectively be retroactive insofar as it affects the terms of a contract previously negotiated. In the absence of a bankruptcy, a creditor would have one set of rules, whereas under a bankruptcy the creditor could be faced with different rules.

Consultations

This issue was debated, but a substantial common ground existed. The stakeholders who support intervention through legislation simply felt that valuable contracts should be able to survive and that creditors should not be able to reap a windfall by enforcing contractual rights in bankruptcy. However, both the creditor and debtor may not always agree on which contracts should survive.

While this might be used as a broad principle for any amendments, stakeholders felt that the present legislation was not in need of serious revision. They felt that concerns in specific areas should be dealt with through specific reforms. For example, if leases or licence agreements were a problem, the system should be amended to address the specific problem. There was some support for a system that would address all executory contracts, although this was not as strongly supported. Broad codification of very specific detailed rules, similar to the U.S. system, was not supported. As a result, discussions focussed on specific issues rather than global solutions.

The specific ideas that received support include:

- providing a change from the existing "material prejudice" test for harm to secured creditors in reorganizations;
- providing some time frame for a trustee to determine how to deal with leased premises in the event of bankruptcy;
- reviewing the present rules regarding property leases in reorganizations as potentially too favourable to tenants;
- addressing the needs of intellectual property, particularly in licensor–licensee relationships; and
- seeking an efficient means of dealing with shareholders' rights and the corporate shell.

The Insolvency Institute of Canada has proposed that under both the *BIA* and *CCAA* the debtors' trustee should be able to terminate contracts, subject to a few specific exceptions and limitations. Their proposal does not simply allow the debtor to walk away from the contract without risk. The proposal would grant the creditor a claim for damages against the estate, although the recovery under that claim may be modest. The proposal also includes provisions for specific issues such as licensing of intellectual property.

7. INTEGRATION OF THE *BIA* AND *CCAA*

The issue

Stakeholders have voiced different opinions about whether the *CCAA* should remain as a separate statute or be merged with the *BIA* and, if so, to what extent.

Background

Canada has two statutes that provide a basis for a corporation to reorganize, the *CCAA* and the *BIA*. The *BIA* is accessible to all businesses, while the *CCAA* is limited to corporations with over $5 million in debt. The decision about which statute a corporation will reorganize under is usually made by the debtor.

The existence of the two acts is a result of historical circumstances. In 1923, *BIA* reorganizations were limited to debtors who were actually bankrupt, not just insolvent. During the Great Depression, the *CCAA* was introduced as a tool for businesses that were insolvent but may not be technically bankrupt. Since that time, amendments have made *BIA* reorganizations more accessible, while modestly restricting access to the

CCAA. *BIA* reorganizations are available to any corporation and are more structured, leading to a greater certainty of the outcome. *CCAA* reorganizations are less structured, are only available to corporations with debts in excess of $5 million and have more flexible terms.

The *CCAA* was rarely used until the mid-1980s, at which time various creative applications increased the Act's popularity. The *CCAA* has been the subject of consideration by various Parliamentary committees and as recently as 1992 it was recommended that it be abolished.

It is difficult to assess the value of the *CCAA*, because there is no provision that requires any reporting of its use. A *CCAA* proceeding is a court proceeding without any supervision by an agency, such as the OSB. Not only are the effects or success of the proceedings unknown, it is not even certain how frequently it is used. We do know that it has been used in some of Canada's largest corporate reorganizations, such as Eaton's, Laidlaw and Algoma Steel.

In a *CCAA* reorganization the courts appoint a monitor, who is not necessarily a trustee. The monitor is required to file reports with the court on the state of the debtor's finances. This is a somewhat similar process to that followed in a *BIA* reorganization. Under the *BIA*, however, it would be a trustee acting in place of a monitor, and reports would be filed with the OSB. Another distinction is that in a *CCAA* reorganization most decisions are made or approved by the courts, whereas in a *BIA* reorganization the court is involved only in major decisions and in approving a proposal that has already been approved by creditors (though not necessarily every creditor).

Considerations

The debate on this issue is constrained by the lack of actual data on the use and application of the *CCAA*. Stakeholders have suggested that the *CCAA* is used in upwards of 50 cases a year, with a typical case involving in excess of $100 million in assets.

The other significant issue is what is meant by integration. Discussions have ranged from taking the *CCAA* provisions virtually intact and adding them as a new and distinct part to the *BIA*, to providing only one regime, perhaps with separate provisions for both large and small businesses.

Creditors have a perception that under the *CCAA* they are disadvantaged. Because of the court-driven process and greater flexibility there is a lack of certainty regarding what may occur in a given reorganization and a feeling that creditors have limited input. There are also administrative issues. There is no means of tracking the effectiveness of the *CCAA* and Canada is the only major developed country with this sort of divided system. Obtaining the background information and achieving a degree of consistency between the two Acts would be easier if the provisions were within the same statute.

Consultations

Greater coordination between the two Acts and establishing some means of keeping track of *CCAA* proceedings were widely supported, although stakeholders cited four primary reasons for not altering the *CCAA* substantially:

- the flexibility of the *CCAA* is a great benefit, allowing for creative and effective decisions;
- bringing the *CCAA* within the *BIA* may make *CCAA* proceedings subject to the levy paid to the OSB;
- the existing *CCAA* is superior to comparable foreign legislation, with similar U.S. proceedings taking two to three times as long at considerably greater cost; and
- there may be a stigma associated with having these reorganizations within a bankruptcy statute.

Generally, stakeholders from the legal community felt that the *CCAA* should stand alone, with some modest technical changes. These changes would include requirements that a monitor be a licensed trustee, to report basic details about a *CCAA* proceeding to the OSB, and to ensure a degree of access to information by interested parties. The technical changes received very broad support regardless of whether the *CCAA* was or was not incorporated in the *BIA*.

While the technical amendments had wide support, the broader issue of integration was the subject of considerable debate. The incorporation of the *CCAA* into the *BIA* without amendment was viewed by many participants as a simpler system and more understandable to those outside our system. They felt that it made no sense having one reorganization scheme within the *BIA* and another outside of it.

There was criticism of the suggestion that association with the *BIA* would create a stigma, given that this structure is typical in most other regimes without any apparent stigma. The criticism is reinforced by the fact that the *BIA* reorganization provisions are used without any apparent trauma. Some also suggested that the lack of rules or certainty can be difficult to explain to parties from foreign jurisdictions.

Use of the U.S. regime was not supported because it is slower and more costly. There was also a concern that the U.S. and Canadian systems are sufficiently distinct that simple adoption of the other system would not be feasible without greater adaptation.

The more dramatic idea of a completely integrated system — involving not just incorporating the *CCAA* in the *BIA* with some new controls, but of substantially modifying

CCAA provisions — was not well received. The benefits offered by the *CCAA* provisions were considered by many to be sufficiently valuable that it would not be beneficial to blend them too much with the *BIA* provisions. Similarly, there was limited support for a repeal of the *CCAA*, given the benefits it was said to contain.

8. DIRECTORS' LIABILITY

The issue

The issue is whether the existing rules on directors' liability strike the appropriate balance between attracting capable directors and creating a sufficient onus to make sure that they act diligently in carrying out their duties.

Background

Directors are exposed to personal liability under a wide range of federal and provincial statutes for a variety of corporate debts. Among the most important are debts for unpaid wages, taxes and environmental damages. In most cases, directors are given due diligence or good faith reliance defences. Yet for some debts — including debts for unpaid wages in the federal labour sector and in some provinces for environmental damages claims — directors are subject to absolute liability: there is no defence.

The exposure of directors to personal liability became a concern in the early 1990s with the mass resignations in the Westar Mining, Canadian Airlines and Peoples' Jewellers cases. A federal government working group established in 1992 to study the matter concluded that although directors' liabilities had increased in the previous 20 years, the marketplace could deal with the problem, and that the risks for directors were manageable. The working group was also of the view that personal liability provisions provide important incentives to directors to perform their duties.

Despite the findings of the working group, the directors' liability issue continued to raise concerns. On two occasions the Standing Senate Committee on Banking, Trade and Commerce recommended measures to limit the scope of directors' liabilities in insolvencies. In its 1996 report on corporate governance, it recommended bringing provisions covering directors' liability for wages into the *BIA*, along with a due diligence defence. This would overrule the absolute liability provisions now in force in some provinces and in the federal labour sector for a company that enters *BIA* proceedings. In its report on the 1997 *BIA* amendments, the Senate Committee again recommended legislating a generally applicable due diligence defence against personal liability for directors in the *BIA*.

Considerations

Reducing directors' exposure to personal liability might encourage competent people to accept directorships and to stay on as directors when their companies face insolvency. This could help to overcome some directors' concerns about the current situation, primarily the uncertainty that the due diligence defence will provide effective protection or that directors' trust funds will be upheld and the cost of insurance. On the other hand, maintaining the current level of exposure might better ensure that wage earners and others who are protected by directors' liability provisions do not see their returns in insolvencies reduced; it would maintain the incentive for directors to make sure that these payments are made.

One option is to place directors' liability for wages directly in the *BIA*, with a due diligence defence. This would increase the protection for directors within absolute liability jurisdictions, but it would reduce protection for wage earners in those jurisdictions.

Placing a broader due diligence defence in the *BIA* that goes beyond wage issues would increase protection for directors in absolute liability jurisdictions. However, it would also reduce protection for the vulnerable or unwilling creditors who benefit from the more stringent protection, particularly in reorganizations.

Another option for increasing protection for directors, particularly during reorganization, would be to exonerate directors from liability for claims arising in the short period before or after insolvency proceedings started. The Insolvency Institute of Canada has put forward one version of this option. Its model would protect outside directors from liability for debts arising within the week before the start of *BIA* or *CCAA* reorganization proceedings. The court would be authorized to establish liens to protect directors against liabilities arising after the proceedings started. Directors also would be protected against claims for severance and termination pay.

An exoneration model of the type proposed by the Insolvency Institute of Canada would provide strong protection to directors, assuring them that they would not be exposed to periodically accruing claims (such as taxes and wages) that come due just before the start of a reorganization. This might overcome the concern directors have over exposure to liability for potentially large amounts — amounts that can lead many of them to resign at the critical time when reorganization is being attempted. The exoneration model would substantially alleviate these concerns and may prevent resignations at a time when the reorganizing company is most in need of their knowledge and experience. On the other hand, these strong provisions could significantly reduce the returns to wage earners and tax collectors in insolvencies.

Consultations

No consensus emerged from the consultations on whether directors' liabilities should be reduced or maintained. Any proposed changes tended to be modest. While the current rules received some criticism, there was no great support for any specific alternative. Several distinct points were raised:

- The current rules were said to leave directors feeling exposed. Even where due diligence defences were available, these defences were said to be too uncertain.
- The differing interests of inside and outside directors were noted. Inside directors have a strong personal stake in the corporation and may be judgement proof anyway, so they are less likely to resign. Outside directors may have a relatively small personal stake in their corporation and are much more sensitive to the impact of directors' liability on their personal wealth and hence much quicker to resign.
- Directors were said to be very concerned about their exposure in reorganizations and were ready to resign on short notice. The practice of the courts in *CCAA* cases to establish charges against the company's assets to protect directors was pointed out. Concern was expressed about making these charges automatic because it could lead to entrenchment of directors that creditors would rather see removed.
- It was suggested that directors should be given the same protection under both the *CCAA* and *BIA*.

Putting provisions about directors' liability for wages in the *BIA* received little support. There was no good reason seen to distinguish wage claims from other claims in that way. It was advised that putting a generally applicable due diligence defence in the *BIA* may not be effective given the uncertainty about the due diligence concept and the protection it provides. Some questioned whether the federal government would have the jurisdiction to enact such provisions.

Some supported the exoneration model for the strong protection it would provide. Others were concerned that it would take too much protection away from the vulnerable or unwilling creditors covered by directors' liability, especially wage earners.

Another model suggested during the consultations would involve focussing efforts on identifying and attacking wrongdoing by directors, but otherwise holding directors blameless in insolvencies. Some stakeholders, however, were concerned about the ability to define and apply the concept of "wrongdoing" and feared the uncertainty would have an adverse effect on the willingness of people to serve as directors.

9. SANCTIONS FOR DIRECTOR AND OFFICER CONDUCT DETRIMENTAL TO CREDITORS

The issue

Concern has been raised that the existing sanctions for inappropriate conduct are not sufficiently balanced to ensure diligent performance while encouraging competent people to act as directors.

Background

Recent court rulings have increased the responsibility on directors to look to creditors' interests when their companies become insolvent. In Canada, directors may now be held personally liable for failure to do so, as is the case in the United States. The level of sanctions in the two countries is now roughly similar.

In previous bankruptcy law reforms (which took place before the recent case law increasing sanctions emerged), increasing sanctions was an important issue, although no measures were enacted. The 1970 Tassé Committee report recommended measures to disqualify directors of bankrupt companies from serving as directors and, in some circumstances, to impose personal liability on directors for deficiencies in company assets. Provisions holding directors liable for creditors' losses were included in bankruptcy bills introduced but not enacted in the late 1970s and early 1980s. In 1986, the Colter Committee recommended that provisions be added to the *BIA* for director disqualification and personal liability for "wrongful conduct."

A different approach to regulating the conduct of directors of insolvent companies was considered in the 1990s: prohibiting "asset rollovers," which are the sale of the assets of a bankrupt company to its principals, primarily its directors. It is typically a phenomenon in small company bankruptcies. Although this has aroused concern among some creditor groups, no such prohibition was adopted.

Considerations

Recent case law developments have made Canadian law more effective in dissuading directors and officers from taking excessive risks in their efforts to revive the fortunes of an insolvent company. These risks are borne by creditors because the shareholders' (often including directors') investment in the company has already been greatly devalued. The law may now treat creditors more fairly and produce more efficient decision making by directors and officers of insolvent companies.

Director disqualification provisions might be effective in weeding out incompetent directors and curbing abuse. But they might be costly to enforce effectively. Depending on how stringent these provisions are, they might also discourage good people from acting as directors because they have to be more cautious of those directorships that they accept.

A prohibition of asset rollovers would address the concerns of creditors who are upset to see the principals of a bankrupt company open up a new business using assets purchased from the bankrupt company at a modest cost — while the creditors remain unpaid. To that extent, such a prohibition might promote bankruptcy system integrity. Yet it might also prevent the trustee from getting the highest price for the bankrupt company's assets, lowering creditors' returns and preventing the best reallocation of the assets.

Consultations

During consultations there was some criticism of the current rules, but concern was expressed about imposing severe sanctions that would discourage competent people from taking on directorships. One recurring concern was the lack of effective enforcement. Several stakeholders said that the current sanctions would be adequate if more resources are applied to enforcing them. Overall, there was no substantial support for major change to this area, because any of the proposed ideas would likely be difficult to implement and ineffective.

There was no consensus either for or against disqualification provisions. Some argued that they would help to curb wrongdoing by directors, but only if sufficient resources were applied to enforce them adequately. Others were concerned that disqualification provisions would discourage people from acting as directors and inhibit decision making by directors.

The majority view on rollovers was that they should not be prohibited — that they typically generate the best returns for creditors and produce the most efficient allocation of assets. Some stated that creditors could protect themselves and do not need such paternalistic protection.

Other suggestions made during the consultations were to give the courts the power to replace directors where appropriate and to establish a national directory of directors. The administrative costs of a national directory were not discussed.

10. TRANSFERS AT UNDERVALUE AND PREFERENCES

The issue

The existing provisions for transfers at undervalue and preferences in the *BIA* may need to be modernized and made more comprehensive.

Background

Transfers at undervalue and preferences occur when a party sells assets for less than they are worth (transfer at undervalue) or makes a payment to one creditor while ignoring another (preference), either when the debtor is insolvent or as a result of the transaction becomes insolvent. These transactions are included in the legislation because they may in some cases be fraudulent, but in any event come at the expense of other creditors.

This aspect of Canada's insolvency law has remained almost untouched since 1919. The growing difficulty with enforcing these provisions has now made them a more obvious concern. The criticism from stakeholders suggests that the provisions, in their present form, are unusable in today's economy.

Based on the comments of stakeholders and examples from some of our trading partners, there are relatively simple changes to the legislation that could improve its effectiveness and better define what transactions would or wouldn't be captured by the new legislation.

A further issue is that the legislation is not sufficiently comprehensive. At the provincial level there are acts governing commercial transactions that have also been used to address transactions of a questionable nature. This fragmentation, with various acts at various levels dealing with similar issues, is both confusing and inefficient. At issue is the question of whether the provisions of the provincial legislation should be included in the federal insolvency legislation to provide a single comprehensive piece of legislation for bankruptcy situations.

Considerations

In some cases, people or corporations facing bankruptcy or insolvency may want to minimize the loss to themselves or to others associated with them. Rather than lose everything, they may transfer assets to family or associates for a token amount. Since the debtors were going to lose the assets anyway, they suffer no loss, while the purchaser gains a valued asset for a small sum. The effect is a reduced value of the bankrupt's estate and ultimately less money for creditors. A similar result is achieved when a debtor selectively chooses to pay one creditor ahead of others, leaving them unpaid.

To resolve these sorts of transactions, existing legislation focusses on the concepts of fraud and intent, which are difficult to prove and may require costly and lengthy litigation. It is an inefficient means of dealing with the problem, but one for which there is a solution. Legislation could focus not on the intent behind the transaction, but rather on the result. If the effect is to deplete the estate, regardless of intention, the transaction could be overturned. The risk in such a change is that those creditors who are simply more diligent in collecting accounts, or a truly unaware third party who receives a good deal from the debtor, could no longer rely on the terms of the deal.

There appear to be two key considerations. The first is making sure that any revision is in fact a workable and effective tool for handling these transactions. The second is trying to resolve concerns that some legitimate transactions might be captured by the new language.

Consultations

The majority view of stakeholders is that the present legislation is not concrete, making it inefficient because of the difficulty, time and expense of applying it. As a result, it is rarely used. Provincial legislation is actually used more frequently.

Support was received for the principles used in some foreign statutes, which do not necessarily rely on the principles of fraud or intent. These include changing the emphasis from intention behind the transaction to the result of the transaction and broadening the scope of who might be party to an undervalue transaction. The latter might be addressed with the use of a more general term like "associate." This could encompass family, friends, business partners or other close associates.

In addition to this change to the existing legislation, there was support for strengthening it by including provisions similar to the provincial legislation on frauds. The view was that one Act with all the relevant elements would be more convenient and easier to work with. That may require some language rendering the provincial statutes inoperative in an insolvency, if that is possible.

Concerns were voiced by creditors' groups and others that these changes may affect creditors who diligently collect on a debt and third parties who happen to negotiate a good deal just before a bankruptcy or reorganization. Discussions regarding the U.S. system indicated that there are provisions in the U.S. legislation to offer some protection for legitimate transactions. Protection for third parties could be as simple as ensuring that their money is refunded or giving them the chance to complete the purchase at a fair value.

GROUP 3

11. SECURITIES FIRM BANKRUPTCIES

The issue

Part XII of the *BIA* may need to be amended to resolve some technical problems that arose during recent bankruptcies of securities firms.

Background

Part XII was added to the *BIA* in 1997 to provide a much needed regime governing securities firm bankruptcies. Its main effect is to override the trust relationship that exists between a securities firm and its customers. Despite the fact that a securities firm holds securities and cash in trust for its customers who have ownership rights in that property, Part XII provides that almost all securities and cash held by a bankrupt firm are to be pooled and distributed pro rata among customers. Only "customer name securities" are to be given to the customers who own them.

Vantage Securities, a Vancouver firm dealing mainly in mutual funds, was put into bankruptcy in early 1998. The main issue concerned mutual funds held in RRSP (Registered Retirement Savings Plan) accounts. The securities in these accounts were pooled, despite customers' wishes that their securities be treated as "customer name securities" and turned over to them forthwith. While it was generally agreed in the end that these securities did not qualify as "customer name securities" and that the pooling was appropriate, it was not clear how Part XII should apply to the securities in these accounts. This led to delays in administering the bankruptcy, which was eventually completed as a proposal under Part III of the *BIA*.

Marchment Securities was a Toronto firm put into bankruptcy in 1999. Marchment held a large quantity of very low-valued securities which, according to Part XII, were transferred in the form of securities rather than as cash. The cost of such a transfer raised a question as to whether Part XII should be changed to permit the trustee to liquidate the securities and distribute cash instead.

Considerations

The issues raised in the Vantage and Marchment bankruptcies are technical and could be resolved by specific changes.

The uncertainty about Part XII's application to the mutual fund transactions involved in Vantage was largely due to its use of a number of paper-based concepts. These concepts included several references to securities "held by" a securities firm, the important definition of "customer name securities," and references to "registered," "endorsement" and "negotiable form." Part XII's application to electronic transactions, as most mutual fund transactions are, could be clarified by substituting language more clearly applicable to electronic transactions.

Two other changes that could be made to Part XII deal with problems emerging from the Vantage case. One is clarifying the definition of "net equity" to make sure that customers benefit by any increase in the value of securities occurring between the date of bankruptcy and the distribution date. The other is clarifying the status of cash in the various accounts of the bankrupt securities firm.

The issue respecting the distribution of low-valued securities raised in the Marchment case could be resolved by authorizing the trustee to sell such securities and distribute the cash, or to charge distribution costs to customers who wish to receive securities in kind.

There is a further possible amendment to Part XII. Trustees who sell securities to raise cash could be required to sell amounts of the different securities in proportion to the amounts on hand. This would assure the fair and equal treatment of customers.

Another possible change would be to make the date of the initial bankruptcy event, which is when a firm's ability to trade usually effectively ends, the date for valuing securities.

Consultations

Stakeholders agreed that specific technical changes to the existing Part XII regime are all that is required to resolve current problems.

12. THE *WINDING-UP AND RESTRUCTURING ACT*

The issue

The issue is whether the use of the *Winding-up and Restructuring Act* in an insolvency should be restricted to financial institutions.

Background

The *Winding-up and Restructuring Act* is the joint responsibility of the Department of Finance and the Department of Industry. It is the only statute under which the major financial institutions — including banks, trust companies and insurance companies — can be liquidated if they are insolvent. It is also available for the liquidation of a wide range of corporations other than financial institutions, including not-for-profit corporations, both solvent and insolvent. These other types of corporations can, if insolvent, also be liquidated under the *BIA*.

Considerations

Given the availability of the *BIA*, there is no apparent reason to allow insolvent non-financial entities to use the *Winding-up and Restructuring Act*. Limiting the use of that Act's insolvency provisions to financial institutions would assist in maintaining the integrity of the system by promoting consistent treatment of firms of similar purpose.

Consultations

There was no opposition from stakeholders to the idea of limiting the use of the *Winding-up and Restructuring Act* insolvency provisions to insolvent financial institutions.

13. FINANCIAL MARKET ISSUES

The issue

Stays of legal proceedings that apply in a reorganization have been held to apply to financial regulators such as securities commissions or stock exchanges. They are concerned about the impact this has had on their ability to carry out their regulatory duties.

Background

Industry Canada has been approached by various provincial securities regulators regarding a recent development related to their regulatory role.

Recent case law has held that the automatic stay of proceedings that occurs if a company files an intention to reorganize under the *CCAA* applies to these provincial market regulators. This stay prevents the regulator from being able to take action against a company that may be conducting itself inappropriately. There is no information suggesting that the stay was or was not intended to apply to these regulators.

Considerations

Securities commissions and stock exchanges have an important role in ensuring the integrity of Canada's financial markets. There is a concern that their ability to maintain this integrity may be compromised if they are unable to carry out their duty as a result of the stay. This situation can occur at a time when their role may be most critical: dealing with a company that is already in financial distress and may be in need of some control or supervision.

Consultations

Generally, stakeholders appeared surprised that the stay would apply to the regulators. They consistently agreed with the idea of exempting the regulatory agencies from the stay provisions. It was suggested by one stakeholder that a blanket exemption may not be needed. Rather, an exemption from the stay would be sufficient to allow these agencies to carry out their mandate.

14. TRUSTEE LIABILITY FOR SUCCESSOR EMPLOYER OBLIGATIONS AND PENSION CLAIMS

The issue

The standard of liability for a trustee that takes on the role of a successor employer needs to be re-examined.

Background

Trustees, receivers and other insolvency administrators, as successor employers, may be held personally liable for a variety of obligations of a bankrupt or insolvent debtor, such as wage and pension claims and claims for environmental damages. Some of these potential liabilities may even be unknown when an administrator first takes on the job. Although subsections 14.06 (1.1), 14.06 (1.2) and 14.06 (1.3) of the *BIA* offer some protection, they do not protect all administrators from all claims.

Amendments to the *BIA* in 1992 and 1997 appear to have provided adequate protection for environmental claims, but concerns remain regarding successor employer liabilities.

Considerations

The risks related to being an insolvency administrator must be sufficiently controlled and identifiable or people would not be prepared to do the work. Although this has not yet been a problem, it would seem fair to make sure that the risks are well balanced.

One concern is that when administrators take on their duties they may not yet be fully aware of the risks they are facing. In particular, they may find themselves subject to liability as successor employers, regardless of the fact that the events giving rise to the liability may have occurred before their appointments.

The types of liabilities that may occur include liability for vacation, severance and termination pay, as well as for unfunded pension liabilities. These amounts can be very large and may even grow while under the supervision of the administrator. Different statutory liabilities for wages and pension exist among federal, provincial and territorial legislation.

Limits on exposure to liability would encourage administrators to accept appointments and carry out essential liquidations. Should the problem not be a result of the administrator's actions, then fairness dictates that they not be held responsible. There may be efficiency benefits as well; the greater protection would encourage administrators to make greater efforts to continue the business and pension plans. These limits, however, would leave the employees and pensioners with one less option for recourse. Any shifting of risk away from the trustee would of course place the risk back on the employee or on any agency that provides compensation.

Consultations

Stakeholders were strongly in favour of increased protection for insolvency administrators. While some limits on the protection were thought to be appropriate to make sure that administrators would carry out their duties diligently, broader protection was supported. Some stakeholders went so far as to propose that successor employer obligations should not survive bankruptcy at all.

V. CONSUMER INSOLVENCY ISSUES

Industry Canada has been reviewing consumer insolvency issues during the last year. It released a discussion paper in April 2002 on all but one of the issues identified in this section, and held consultations in May and June of 2002. The views emerging from those consultations are reported here.

Consumer insolvency issues have also been reviewed over the past two years by the Personal Insolvency Task Force. The Task Force was established by the Superintendent of Bankruptcy in October 2000 and includes 23 consumer insolvency stakeholders such as creditors, trustees, debt counsellors, lawyers and judges. It was asked to review the consumer bankruptcy provisions of the *BIA*, explore alternative models of the consumer insolvency process and develop recommendations for improvements to the process. Its report is expected to be released in the fall of 2002. The Task Force examined several — but not all — of the issues outlined in this report, as well as other issues mainly of an administrative nature that are not discussed here.

Some issues discussed in this report have existed for some time, but have not been resolved in previous reforms. Others have largely emerged since the recent reforms, namely the growth in consumer bankruptcies and streamlining the administration of such bankruptcies.

The high and growing number of consumer insolvencies came to prominence after 1997. The OSB identified the pressure that the high number of insolvencies was exerting on its administrative resources. Furthermore, consumer insolvency stakeholders raised concerns about the possible links between the high insolvency numbers and the general financial situation of consumers.

The streamlining issue relates to high and growing consumer insolvencies and the pressure this is putting on OSB resources. Streamlining consumer insolvency administration has been identified by the Department as one possible means of relieving the pressure.

The issues can be broadly classified into three groups, where:

- there are contentious differences among stakeholder groups about what policy should be followed. These include federal exemptions and whether RRSPs should be exempt.
- there are significant differences among stakeholders, but the differences do not appear to be insurmountable and can likely be resolved to general satisfaction through technical amendments. These include reaffirmation agreements; the streamlining of summary administration bankruptcies; the exemption of RESPs; the enforcement of security on a bankrupt's household property; and mandatory counselling.
- there is general support for a particular course of action. This group includes consumer liens, growth in consumer bankruptcies, student loans, and wage assignments.

GROUP 1

1. FEDERAL EXEMPTIONS

The issue

It has been suggested a number of times that the *BIA* should incorporate a list of assets exempt from seizure in bankruptcy.

Background

Responsibility for setting exemptions in bankruptcy was relegated to the provinces in the Canadian *Bankruptcy Code* of 1919. The issue was little discussed until 1970, when a committee established by the government to review the *Bankruptcy Act* recognized the benefits of a federal exemptions list and concluded that there was no constitutional reason why such a list could not be included in federal insolvency legislation. The committee recognized that the economies of the various regions may dictate different considerations for deciding what property should be exempt from seizure. The issue was considered again in 1994 by the Bankruptcy and Insolvency Advisory Committee, appointed by Industry Canada. No changes ensued from either of these initiatives.

Considerations

Exemptions play an essential role in helping bankrupts reintegrate themselves financially into their communities. They enable a bankrupt individual to retain basic necessities of life such as clothing, household furnishings, appliances, medical aids, a basic homestead exemption (in some cases), and property an individual needs to pursue his or her livelihood, such as tools of the trade and other equipment.

Critics argue that the current *BIA* provisions, which accommodate exemptions established at the provincial level, do not provide for the equitable treatment of bankrupts across the country. The exemptions vary widely among the provinces and territories, both the amounts and the types of property that are exempted. The result has been a significantly different treatment of debtors' estates, depending on the residence of the debtor and the location of the property at the time of bankruptcy.

An alternative approach, proposed by the Task Force, recommends an optional list of federal exemptions that would be periodically adjusted for inflation. Bankrupts would be free to choose between the federal and applicable provincial exemptions upon filing for bankruptcy. The Task Force proposes a federal list of the following exemptions:

• apparel and household furnishings:	$7500
• medically prescribed aids and appliances and medication for use or consumption by the debtor or the debtor's family:	no limits
• one motor vehicle whether used for personal, trade or business purposes:	$3000
• tools of the trade and professional books, but not including motor vehicles used in the trade or business:	$10 000
• debtor's residence (in the case of a joint filing, each debtor will be entitled to the full exemption):	$5000
• real and personal property used by a debtor whose livelihood is derived from farming, fishing, forestry and other activities related to the natural resource sector:	not less than $10 000 and not more than $20 000 (governed by provincial or territorial law)

The Task Force proposal offers a reasonable alternative to the current provincial exemptions, both in the exemption amounts and the scope of the property covered. By compensating for the effects of inflation through regular increases to exemption limits, the eroding effects of inflation would be negated. The Task Force attempts to account for the differing regional economies throughout the country, particularly the Prairies and the East Coast, which rely heavily on farming and fishing.

Consultations

This was perhaps the most divisive issue discussed during the consumer consultations.

Some stakeholders supported a federal exemption list and felt that the uneven provincial exemptions currently in place are unfair. Others viewed such a list as an intrusion into an area that is already adequately dealt with by the provinces and that reflects the needs of each region.

Part of the difficulty in reaching a consensus was that among those who did support a federal exemption list, views on how to do so varied considerably. The U.K. and Australian regimes did not receive much support because of the uncertainty they create through the involvement of courts and lack of a capped amount. The Task Force model was more enthusiastically received, as it sought fairness while still allowing provinces to provide for regional disparities as appropriate. However, there was substantial concern expressed over the idea of having the option to use either the federal or the provincial list. Many felt that to have both lists available would still fail to ensure fairness while further complicating the system.

Ultimately, among those who supported a federal exemption list there were three main groups: those who like the Task Force proposal in the form it was proposed; those who support a federal exemption list as a minimum standard that would apply when provincial standards were lower; and those who support a federal system in place of the existing provincial systems.

Many sources criticized the concept of having any federal exemption list, including some national lenders, who, despite the convenience of dealing with a single federal system, pointed out that the current system is working, it is built into their lending practices, and they have outstanding loans on the basis of the existing rules. Trustees were divided as to how much extra work would be involved, but they did acknowledge that an option of a federal or provincial list would increase the workload. Ultimately, much of the concern centres on whether a problem actually exists. Other than the fundamental issue of providing some degree of fairness, stakeholders question whether the federal government should be intervening if some provinces have chosen not to modernize their exemptions as frequently as others. If it is simply fairness at stake, the use of two lists will not achieve it.

The only consensus that was reached was that any list, whether federal or provincial, should have set limits, unlike the U.K. model. The suggestion that there should only be one list, whether it be federal or provincial, also received some degree of support.

2. EXEMPTION OF RRSPS

The issue

It has been suggested that Registered Retirement Savings Plans (RRSPs) should be exempt from seizure in bankruptcy, as is the case for Registered Pension Plans.

Background

In 1986, the government appointed the Advisory Committee on Bankruptcy and Insolvency, which recommended an exemption from seizure in the event of bankruptcy for up to $50 000 in RRSPs. In 1994, another committee, the Bankruptcy and Insolvency Advisory Committee, also recommended that RRSPs be exempt from seizure. Neither of these recommendations was adopted.

The Uniform Law Conference of Canada considered the issue of exempting RRSP savings against debt enforcement and in 1999 proposed uniformity of provincial legislation exempting RRSPs. To date, none of the provinces has adopted the provisions of the uniform act.

Considerations

Currently, RRSPs held by banks, by brokerages or in self-directed RRSP accounts are not exempt from seizure in the event of bankruptcy. By contrast, funds invested in Registered Pension Plans are exempt by virtue of provincial and federal pension benefits legislation and RRSPs held by insurance companies are exempt under insurance legislation.

It has been argued that an individual's retirement savings should have the same protection against seizure, whether they are in a pension plan, insurance company RRSP, or other type of RRSP. If the public policy basis for encouraging Canadians to contribute a portion of their earnings for retirement through RRSPs is to ensure that senior citizens have a reasonable standard of living in retirement, then granting conventional RRSP vehicles the same protection obtained with insurance type RRSPs and Registered Pension Plans would seem to make sense.

A number of arguments have been made against exempting RRSPs. First, doing so would reduce returns in bankruptcy situations to creditors, including the Crown. Second, RRSPs can be used for non-retirement purposes and most RRSPs can be redeemed at any time. This creates a concern about how they should be treated relative to a defined benefit plan so there is no abuse. Third, RRSP holders already have an option to protect their investments in bankruptcy. They can use an insurance scheme based on locked-in plans, which are protected in bankruptcy.

The Task Force has recommended an RRSP exemption aimed at balancing debtors' and creditors' interests and discouraging strategic investment behaviour. Its essential elements are as follows:

- to be exempt in bankruptcy, an RRSP would have to be locked in at bankruptcy and made accessible only upon reaching retirement age;
- RRSP contributions made by the debtor in the three years before bankruptcy would not be exempt;
- the income from an RRSP drawn following a person's retirement would be treated as income and subject to the surplus income standards in the *BIA*; and
- the exemption would be capped by a formula equal to the maximum RRSP contribution limit in the year of bankruptcy times the number of years that the bankrupt's age exceeds 21.

The Task Force's model has some important advantages. It would ensure that the savings are used for retirement purposes and not for the purposes of a strategic bankruptcy. The incremental formula for determining a debtor's maximum exemption amount would allow older individuals to keep more of their savings as they near retirement. Likely the maximum exemption would be less than the present value of the entitlement under a Registered Pension Plan.

Consultations

During the consultation sessions across the country, a modest consensus emerged in favour of exempting RRSPs from loss in a bankruptcy, with a similar level of support for some controls on the exemption. This issue alone also attracted significant written comments from stakeholders, who were largely in support of an exemption.

There were two opposing views on this issue. The first equated an RRSP to a Registered Pension Plan (RPP) and, given the importance of retirement savings, accepted that they should be protected. This was further emphasized by the fact that, increasingly, Canadians do not have an RPP to fall back on. The second saw RRSPs as just another investment. While many thought that the two types of plans should be treated similarly, some wondered if perhaps we should make both accessible rather than exempt. Specific concerns over exempting RRSPs included the following:

- Certain RRSPs are secure from seizure. To offer retroactive protection on others would be to provide bankrupts a protection that they chose not to avail themselves of when they made the investment.
- Those who, in selecting a retirement investment strategy, have chosen other vehicles such as real estate or stocks, should perhaps be protected as well.

- Debtors often use RRSPs now to pay creditors; if shielded, they may be less inclined to do so.
- RRSPs are often not purchased with retirement as the intended purpose.
- Exempting RRSPs would offer protection to the well-off but would do nothing for those who are neediest.
- More research is needed to determine the effects of such an exemption.

The Task Force proposal was supported by many as a reasonable balance between offering protection and ensuring the continued integrity of the system; however, even the limits proposed by the Task Force were subject to various criticisms. With respect to a cap or limited exemption, some felt that there should be none (as is the case in recent Saskatchewan legislation) or that the cap should simply reflect whatever figure would have been accrued under the Canada Customs and Revenue Agency's allowable contribution for that individual. One stakeholder even suggested that the cap should not be based on the amount of time a bankrupt has been contributing, but on how long they still have to save for retirement. On the issue of a clawback for recent contributions, some felt that a three-year period was too long, that the clawback should reflect the performance of the investments and that this issue could be dealt with under existing legislation if the contribution was seen as intended to shield assets. There was also some question of the tax implications of a clawback, given that a deduction may have already been granted. Finally, regarding the lock-in requirement, some stakeholders indicated this would be hard to implement. It was also noted that the idea of allowing the debtor the option of locking in the RRSP is a bit misleading; if the alternative would be to lose it entirely, it is clear which option the debtor would choose.

GROUP 2

3. REAFFIRMATION AGREEMENTS

The issue

Stakeholders have voiced concern whether reaffirmation agreements that re-establish a debt that was eliminated by a bankruptcy should be permitted.

Background

A debt reaffirmation occurs when a bankrupt revives or reaffirms personal responsibility for liabilities that have been eliminated in bankruptcy.

Reaffirmation agreements are not regulated in the *BIA* and statistics about the prevalence of these types of arrangements are not available in Canada. Anecdotal evidence suggests that creditors are having Canadian bankrupts enter into reaffirmation agreements for old debt as a condition of obtaining new credit. In the United States, estimates exist that reaffirmation agreements are entered into in over 19 percent of cases.

Two forms of reaffirmation agreements exist. Reaffirmation agreements by conduct are those where the bankrupt continues to make payments for a debt after bankruptcy even though the payments should have been extinguished. The courts have upheld reaffirmations by conduct. Reaffirmation agreements can also be established by express written agreements. Written agreements will likely be enforceable where sufficient or new consideration is offered, such as a creditor's undertaking to provide a new loan.

Considerations

Our bankruptcy legislation gives Canadians the opportunity for a fresh start, free from the burden of an unmanageable debt load. Creditors can no longer seek payment for debts that existed before the bankruptcy. Nevertheless, bankrupts and creditors appear to be reaching agreements that reaffirm pre-bankruptcy debts, potentially eroding the benefits of the fresh start principle.

Decisions upholding reaffirmation agreements have been criticized for subverting the fresh start principle. It has been argued that many bankrupts will not appreciate that continuing to make payments on a debt may lead to its reaffirmation. Consequently there may be potential for creditors to urge a bankrupt to continue payments on a debt once he or she has declared bankruptcy, irrespective of the fact that the debt has been extinguished by the bankruptcy. On the other hand, reaffirmation may be the only means a debtor has to obtain credit.

The Task Force concludes that the *BIA* should limit the scope for reaffirmation agreements. The view is that reaffirmation agreements concerning unsecured transactions should not be permitted, however, some payments may be allowed if approved by the official receiver or the courts, or if voluntarily made to a relative. The Task Force recommends that reaffirmation agreements in respect of secured transactions should be allowed only in limited circumstances. Its key recommendations are that:

- reaffirmation agreements must be in writing and entered into within nine months of the date of bankruptcy;
- the assets involved must remain in the possession of the bankrupt or his or her family;
- the bankrupt must be given the right to rescind the reaffirmation agreement for 90 days from the date it was signed;

- reaffirmation agreements must be reported to creditors;
- the amount that may be reaffirmed must be no greater than the balance of the outstanding debt at the date of bankruptcy, nor may it exceed a specified percentage of the value of the asset; and
- an offence be created for collecting a reaffirmed debt not meeting these requirements.

Another option would be to prohibit all reaffirmation agreements by a bankrupt, regardless of the circumstances. This approach would be consistent with the fresh start principle and would place bankrupts in a better position financially after receiving their discharge from bankruptcy. But this might substantially affect credit availability.

Consultations

Stakeholders generally agreed that except in a few specific circumstances, there should not be any legislative intervention to control reaffirmation agreements. In fact, the point was repeated on several occasions that while some debts may be renegotiated, such as a mortgage, efforts to pay debts that have been eliminated through discharge should be encouraged, possibly even rewarded.

Stakeholders were concerned that despite evidence of reaffirmation being relatively frequent in the United States, it has not been a common occurrence in Canada. In cases where it has occurred, it has often not been an example of objectionable conduct by the creditor. A particularly high degree of consensus emerged regarding control of reaffirmation agreements in circumstances where coercion is used by the creditor as an inducement to make good on the debt. There was also concern related to reaffirmation by conduct; however, this can take many forms which may need to be assessed differently. For example, secured versus unsecured debt, or cases where a contract has been continued by both parties versus one in which a debt is simply revived.

Concerns over abuse do exist and were clearly stated by some stakeholders; however, in the absence of evidence of a substantial problem, and given the view of many that this is a positive gesture when made by debtors, there appears to be little appetite for any intrusive action. Trustees suggested that as a matter of course, they typically warn debtors of this sort of situation and that the debtor is not obliged to repay the debt. Some creditors were against reaffirmation on the basis that it allows the debtor to selectively pay one or more, but not all, of their creditors, and therefore reaffirmation should be eliminated.

Another issue that arose was that in cases where reaffirmation may be in the best interests of both parties, great care would be needed to ensure that such a transaction was still possible. Examples raised related to accommodation and vehicles.

The Task Force proposal was partially supported, and although stakeholders acknowledged the distinction between secured and unsecured debt, the general view was that there was no justification in distinguishing among creditors. Coupled with concerns over how reaffirmation agreements could be supervised, and a very strong opposition to the Task Force recommendation that inappropriate payments be the subject of criminal sanctions against the creditor, it appeared that stakeholders would want any control to be focussed on coercion and reaffirmation by conduct.

4 STREAMLINING SUMMARY ADMINISTRATION

The issue

Suggestions to simplify procedures for consumer bankruptcies have been made, particularly in the case of the debtor with only token assets and a modest income.

Background

Canadian bankruptcy legislation was originally developed to resolve business failures. Summary administration provisions, which were intended to provide a simpler and cheaper way to administer the bankruptcy process for debtors with few assets, were not added to the *Bankruptcy Act* until 1949.

The summary administration procedures apply to non-corporate bankruptcies where the realizable assets do not exceed $10 000. In summary administration estates, several of the procedural requirements of the full administration process are omitted or streamlined. For example, newspaper publication of bankruptcy notices is not required, some of the forms are simplified, meetings of creditors are held only on request, inspectors need not be appointed, and trustee accounting and discharge procedures are simplified. Nevertheless, the process remains fairly complex. It involves an initial assessment interview of the debtor by the trustee, sending creditors a notice of bankruptcy, a statement of the debtor's affairs and forms relating to creditors' meetings, and proofs of claim. The trustee must prepare a report on the bankrupt's affairs, the causes of his or her bankruptcy, the debtor's conduct before and after bankruptcy, other matters relevant to whether the debtor should be discharged unconditionally where a debtor has surplus income, a recommendation as to whether the debtor should be discharged, and a statement of receipts and disbursements accounting for all money received and disbursed. The OSB and creditors have the right to get involved at various stages in the process, to request creditors' meetings, to oppose the trustee's recommendations, or to oppose the debtor's discharge.

Considerations

In recent years, consumer bankruptcies in which the debtor has few or no assets and low income have accounted for a large percentage of bankruptcies. In most of these bankruptcies there is no question of dishonesty or wrongdoing, and hence no reason for such an enquiry. The worst that can be said is that the debtor is poor at managing finances and is overwhelmed with debt. Creditors have little reason to take an interest in these cases. Their prospects of getting a return are slim. It would seem most efficient to try to process these bankruptcies as quickly and cheaply as possible.

The overall costs of administering these bankruptcies can be large. They require time and effort on the part of the trustee, the OSB, the creditors and the courts, as well as the debtor. There is room for streamlining. One approach was developed by the Task Force. Its approach would retain the existing summary administration process, but modify it to eliminate procedures that add no value. The creditors, the OSB and trustees would be able to get involved in summary administration bankruptcies selectively. For example, their right to intervene to call meetings or request information would be retained. In line with this approach, some key administrative tasks — such as the preparation of the trustee's report on the bankrupt's discharge, and the distribution of the statement of receipts and disbursements — would be required only if creditors request them.

This approach would significantly reduce the administrative burden in summary administration bankruptcies. It is estimated that in about half of summary administrations, there would be no need for the trustee to prepare a report or distribute statements of receipts and disbursements to creditors. But significant administration costs would remain. There would still be the assessment interviews for the trustee to carry out. Creditors would still have the option of getting involved in the process, requesting creditors' meetings, reports or copies of statements of receipts and disbursements, or opposing discharges. All these events would generate costs. On the other hand, by providing for some debtor involvement and enabling creditors to participate, this approach would help to ensure that the *BIA* continues to promote the integrity of the consumer credit system and prevent abuse.

A more radical change would involve ascertaining at the outset whether a consumer debtor fell within the low asset and income category and from that point providing practically no occasion for creditor involvement and no information other than notice that the debtor was bankrupt. Administration costs would be reduced to the barest minimum. The Australian *Commonwealth Bankruptcy Act* has a procedure along these lines, where the debtor files for bankruptcy, often by mail, and the creditors get little more than a notice of bankruptcy.

A major challenge with this approach would be to protect the integrity of the credit system and prevent abuse. One means might be to delay discharge for three years, during which the debtor would be required to report income and contribute surplus income to his or her estate. The three years would compare to the length of a typical consumer proposal. In effect, an insolvent individual debtor considering possible *BIA* solutions to his or her problems would have the option of negotiating a voluntary three year partial debt payment plan with his or her creditors under the consumer proposal provisions of the *BIA*, or would pay some of his or her debts involuntarily by going bankrupt and making surplus income contributions over the same three years. This would discourage debtors from looking at bankruptcy as an easy way of getting rid of debts and would encourage them to make maximum efforts to pay them outside bankruptcy or to negotiate consumer proposals.

A radically streamlined regime would further reduce administration costs. By delaying discharge for three years, such a regime would encourage consumer proposals and bring the obligations of bankrupt debtors more into line with those of debtors making consumer proposals. On the other hand, it would also reduce the *BIA*'s ability to protect the integrity of the credit system and counter abuse. More reliance would be placed on a debtor's honesty in reporting his or her state of affairs and income. There also would be less monitoring of the debtor's conduct by the OSB, trustees and creditors. Delaying the discharge for three years would provide a check on debtors' incentives to abuse the system, but it would mark a major departure from the fresh start principle.

Consultations

While streamlining was supported, most stakeholders agreed that this should be done through selective changes rather than by any comprehensive overhaul of the system.

Generally, most participants believe that our present system works well and is well regarded internationally. However, improvements that might lead to cost and time savings were seen as a possibility. For example, the use of electronic document filing was encouraged. Some even suggested that further changes should be delayed until the OSB has completed its move to electronic filing to determine what effect this has on the system.

There was no support for a radical streamlining that would vastly reduce paper flow and simplify the process. The principal concern was that the radical streamlining option was very much open to abuse in a system that is already the subject of criticism for its ease of access. That point was raised not only by creditors but also by trustees and other groups. The trustees raised another concern, which is that their work involves a significant amount of counselling, not only of a financial nature. A bankrupt is often distraught: the radical approach would eliminate much of the personal aspect of the trustee/bankrupt relationship, and the ability to counsel both financially and otherwise would be lost. The possible delay in discharge that the radical approach offered was also criticized as being unfair to those who go through the summary administration process. A final concern is the responsibility that would be placed on the bankrupt to interpret and complete paperwork without assistance which, trustees pointed out, would be challenging even for the well-intentioned debtor. This could affect the integrity and reliability of the process.

The Task Force proposal received some support as being a good balance between creditor and debtor interests in those cases where the debtor has few assets and a low income. However, several participants indicated that they find the reporting requirement of section 170 of the *BIA* useful for a variety of reasons and would prefer that it be maintained.

Interestingly, one idea which did recur throughout the consultations with a reasonable degree of support from a wide range of stakeholders was that the period before discharge should be extended, perhaps to 15 months. Such an approach would allow for the passage of a full tax cycle, provide more time to counsel the debtor, and help ensure obligations for payment of the trustee are met.

Apart from the issue of the discharge period, most of the suggestions made related to technical points, which would not alter the system in any substantive way. Stakeholders did not see any reason for a dramatic streamlining that alters any of the fundamental principles that support the present system.

5. REGISTERED EDUCATION SAVINGS PLANS

The issue

Should amounts contributed to a Registered Education Savings Plan (RESP) be exempt from seizure if the person in whose name the account is held goes bankrupt?

Background

RESPs have existed under various names since 1960, and since that time have gone through two notable changes: they were granted a tax-sheltered status; and they are eligible for a matching program in which the federal government contributes to the savings plan (to a maximum of $4000 per year) based on the contributions of the plan holder. In the event of a bankruptcy of the plan holder, the existing balance can be seized to pay creditors, while the government contributions are forfeited to the government.

RESPs are generally collapsible prior to being needed for education, and the proceeds go to the plan holder, typically a parent.

Considerations

The fundamental concern is balancing the fairness of exempting another asset from seizure with the public interest of promoting education.

Government action to shelter and top-up these accounts certainly indicates a support for them, and promotes them as a vehicle for encouraging education. Education is obviously a positive contribution to society; however, providing an exemption in bankruptcy has a negative impact on creditors.

Concern exists for both creditors and insolvency practitioners regarding additional exemptions. Certainly any exemption would reduce the size of the estate distributable to creditors, resulting in greater losses. Although the individual loss to a particular creditor in a particular bankruptcy would likely be modest, the overall loss to creditors across all bankruptcies may be appreciable. There is also concern that further exemptions and prioritizing of claims are slowly eating away at the fundamental purpose of bankruptcy, which is the fair and efficient redistribution of assets.

Consultations

This issue was also discussed in each city, with a presentation made in Ottawa on behalf of the RESP Dealers of Canada. The question is whether RESP accounts should be exempt from seizure in a bankruptcy, a similar issue to that of exempting RRSPs, where issues of public good and fairness to all parties are the focus.

RESPs are generally seen as investments for a good purpose, and this view was supported by stakeholders at the consultations. Although this issue did not raise a great deal of discussion, comments were supportive of offering an exemption; however, conditions similar to those discussed for RRSPs were also supported, such as a lock-in requirement. The RESP Dealers of Canada proposal also suggested a clawback of the last year's contribution.

An alternative suggestion was that these plans be made to meet the formal requirements of a trust, thereby avoiding seizure. This option would somewhat lessen the flexibility of such plans.

6. ENFORCEMENT OF SECURITY ON A BANKRUPT'S HOUSEHOLD PROPERTY

The issue

Security agreements on a debtor's household property sometimes are enforceable after bankruptcy. The issue is whether this should be changed.

Background

In most Canadian provinces, it is possible for a creditor to take as security the personal property found in a person's home. In cases where the consumer becomes insolvent or declares bankruptcy, a creditor may seek to take advantage of a bankrupt's desire to keep this property, ultimately obtaining more than the property is worth by threatening to seize the assets. This is often the case as well for personal vehicles, which may be essential to a person's family or for employment purposes.

This practice has been strongly criticized by some commentators, who contend that it is abusive and unfair towards bankrupt individuals and their families. It has been disallowed in the United States under the U.S. *Bankruptcy Code* and in some provinces. The Task Force has given the issue considerable thought and has raised concerns.

Considerations

The rights of secured creditors are rarely affected in a bankruptcy. There are no mechanisms in the *BIA* to protect personal property of a bankrupt that would otherwise be exempt under provincial law. Furthermore, the lack of remedies to protect a debtor's equity in the property or to retain the property through some form of negotiated agreement with the secured creditor has been criticized as unfair and punitive.

The U.S. *Bankruptcy Code* offers more protection for personal property held primarily for personal, family or household use, or property used for employment such as professional books and tools of the trade. Security interests in those assets, other than purchase money security interests, in which the assets were bought with the loan funds, are not enforceable.

The Task Force recommends that all non-purchase money security interests granted by the debtor against personal property should be unenforceable in bankruptcy and consumer proposals. It also recommends stronger protection for assets that are exempt from seizure, including a requirement that a secured creditor must pay the exempt amount to the debtor before enforcing.

The Task Force's recommendations would address the main criticisms that have been made against the current state of the law. Limiting the scope of security interests in household furnishings, however, may affect the availability of credit for the purchase of these items.

Consultations

Strong support existed for control of agreements that use household property as security, which would otherwise be exempt from seizure. If the goods bought with the credit are the security, they would be seizable (a purchase money security interest) whereas if the security is on goods other than those purchased with the credit, they would not be seizable (a non-purchase money security interest). Although this issue, like several others, could be left to provincial consumer legislation to address, it appears different because many viewed such agreements as a collection tool rather than a real security agreement.

Although several stakeholders felt that this, too, was an issue that provinces could deal with if they choose, and that in any event the bankrupt agreed to offering their household belongings as security, this was not the commonly held view. Those who supported controls did so for several reasons:

- Often a bankrupt is not aware of what he or she is agreeing to when signing the document.
- In stakeholders' experience the creditor generally has no intention of taking the goods but uses the threat as a means of pressuring someone to pay.
- This is not the type of agreement used by much of the lending community, and would be unlikely to affect credit availability if barred.

While the U.S. model was not well supported because of the higher frequency of court intervention for such issues, the Task Force model received broad support. Criticism of the Task Force model tended to be of a more technical nature, such as the need for very clear definitions and the difficulty involved in valuing assets. The overall view that emerged was that at a minimum, two points need to be dealt with. First, unless there is a purchase money security interest, these security agreements should be inapplicable to property that would otherwise be exempt from seizure. Second, although vehicles are frequently the subject of provincial exemptions and occasionally the subject of a non-purchase money security interest, they are used as security and are a real and saleable asset unlike other household belongings. For this reason, it was suggested that vehicles should perhaps be treated differently than other household belongings where the security might be used more as a pressure tactic.

7. MANDATORY COUNSELLING

The issue

A debtor who is bankrupt or has made a proposal is required to participate in counselling. The question is whether this should be made optional.

Background

Mandatory counselling provisions were first added to the *BIA* in 1992. Under the 1992 provisions, the trustee was obligated to provide for counselling for an individual bankrupt and could also provide counselling for someone "financially associated" with the bankrupt. The costs were to be paid out of the bankrupt's estate. Bankrupts who refused or neglected to receive counselling were made ineligible for automatic discharge. Counselling was also required for debtors making consumer proposals.

The counselling program was evaluated by the OSB in 1994 and again in 2001. The 2001 evaluation showed counsellors and debtors to be positive about counselling, more so than in 1994. Most counsellors and insolvents supported mandatory counselling, especially the first session on financial management education. Counsellors felt that the program has had a positive effect on changing behaviour and on the ability of insolvents to avoid future bankruptcies. Insolvents are very positive about counselling's effect on their ability to manage their financial affairs.

The evaluators concluded that the mandatory counselling program should continue, noting that a majority of counsellors and insolvents believe it to be effective in providing useful knowledge and skills. The evaluation report found that support for mandatory counselling had increased between 1994 and 2001.

Considerations

The evaluations of the counselling program indicate that counselling yields significant benefits: producing positive behavioural changes in insolvent debtors, increasing the ability of insolvent debtors to manage their financial affairs, and providing useful knowledge and skills. Further, counselling appears to have had little impact on the operating costs. The costs of counselling an insolvent debtor are to be paid out of the estate, which in effect would mean by the creditors. In essence, creditors would be providing a valuable service to debtors, albeit one that would provide benefits to creditors in future to the extent that debtor financial management improves.

An alternative approach would be to make counselling optional at the discretion of the debtor, the trustee, or the OSB. Counselling at the debtor's option would make sure that only debtors seeing value in counselling would get it. The retention of information provided to these debtors would presumably be better than for debtors taking counselling only because it is required. Nevertheless, overall net benefits might not be higher than with mandatory counselling because some debtors who would not take counselling voluntarily could benefit from it.

Consultations

While consensus did emerge in support of counselling, with suggestions as to how it may be improved, there was some question as to its value in certain circumstances.

Generally, stakeholders see counselling as a valuable means of improving a bankrupt's ability to deal with money and budgeting, and they anticipate this would reduce the incidence of second-time bankruptcies. Several trustees who conduct counselling indicated that their counselling skills had improved and that they were now better able to perform this function than when it was first introduced. They did suggest that supplementary materials and training could be improved. While there was some discussion regarding who is best suited to do counselling — trustees or outside counsellors — there was no resolution on that point.

A common theme related to this topic, and others, was that counselling at the time of bankruptcy may be helpful, but a comprehensive education program on personal finance for young people would be more useful. Many suggested that high school or even sooner would be the best time for this and that it should not be cursory. The Canadian Banker's Association indicated that they have been sponsoring a voluntary national program that provides a presentation to students. As well, it was pointed out that in British Columbia there is a high school component devoted to this topic. There was a further suggestion that more counselling, perhaps by some kind of independent counsellor, should be required prior to being able to declare bankruptcy. However, trustees indicated that they already spend considerable time doing this and ensuring that bankruptcy is the appropriate action, to the extent that they often refer people to other options and agencies.

On a more technical note, considerable support existed for additional counselling, perhaps through a mandatory third counselling session. Similar support existed for the idea that counselling be made an absolute requirement in all cases as a condition to obtaining a discharge and that the timing of the existing counselling might be changed.

The most frequent criticisms of mandatory counselling followed two lines of thinking. The first was that by the time someone reaches the point of bankruptcy, it is too late for counselling to be effective or have a significant impact. Many of those who felt this way were supportive of some kind of earlier education program. The second was that in many cases, a bankruptcy is not the result of mismanagement by the bankrupt, but rather the result of a business failure, job loss or marital breakdown. In such cases, trustees noted that it was both embarrassing and unproductive for them and the bankrupt to go through this process. While many concurred, they thought it would be too difficult to create an exemption and identify which bankrupts may not require counselling; therefore, it should remain mandatory.

GROUP 3

8. CONSUMER LIENS

The issue

Consumers who place deposits on goods or services with a vendor, but who never receive those goods or services because the vendor subsequently declares bankruptcy, are presently unprotected.

Background

From time to time retailers go bankrupt, leaving consumers with no more than unsecured claims and little chance for recovery. Consumers invariably feel aggrieved in these situations because they do not regard themselves as creditors and did not intend to incur risk. A consumer lien would improve the likelihood of recovery.

The consumer liens issue was raised at the federal level in 1991–92 during hearings before Parliamentary committees reviewing the amendments to the *BIA*. The protection proposed in the 1992 legislation for unpaid suppliers was noted and it was suggested that consumer depositors are even more vulnerable and in need of protection. No consumer lien provisions were adopted in 1992.

British Columbia enacted consumer liens legislation in 1993. It established a "buyer's lien" — a security interest applying to purchases of unascertained or future goods for personal, family or household use. The lien covers all accounts of the retailer into which consumer deposits are paid and goods in the retailer's inventory that are of the same description as the goods ordered. This buyer's lien ranks ahead of claims of secured creditors.

The Bankruptcy and Insolvency Advisory Committee considered a federal consumer lien in its 1993–94 deliberations, but made no recommendation. No such provision was included in the 1997 amendments.

Considerations

Consumer liens primarily have fairness objectives. Consumer depositors are seen as vulnerable creditors, needing special protection. As with all proposals to give statutory protection to a specific group of creditors at the expense of other creditors, an important question is whether the departure from an equal payment principle is warranted. There is also the consideration as to whether these measures might adversely affect credit availability.

While the *BIA* does not provide for consumer liens, if tested it may be held to recognize consumer liens established under provincial law. If it were deemed desirable to provide protection nationwide, a federal lien could be put in the *BIA*.

Another approach, similar to that provided in the United States, would be to give preferred status to claims for consumer deposits, ranking them ahead of ordinary creditors' claims but behind secured claims. Preferred status would provide weaker protection to consumer depositors than a consumer lien, but would also have a less potentially adverse effect on credit.

Consultations

A substantial consensus was reached that supported leaving this issue to be dealt with through provincial commercial/consumer legislation, as, in the view of most stakeholders, it is not a significant problem. Although it was raised that this issue could also have been dealt with as a commercial insolvency topic, the input received was considerable and worthwhile.

Many trustees and creditors indicated that, to the extent possible, they would be happy to complete the transaction for consumers who have placed deposits on goods with an establishment that then goes bankrupt. However, given that this is often not possible, there was concern regarding trustees' ability to deal effectively with such situations. While some establishments may maintain good records of such transactions, not all do, and it was suggested that the administration that would be involved for amounts that are often individually quite small would be burdensome, perhaps to the point of discouraging trustees from accepting the file.

While some suggested that fairness would be served by providing some compensation in these circumstances, there were again differences over how to accomplish it. Many felt that the best method would be to require deposits of this nature be deposited in a trust account. This, however, is beyond the scope of bankruptcy law. The U.S. preferred status option was considered, but it was generally viewed as impractical as it is more complicated than a simple priority and still does not guarantee recovery.

Given the perception that this is a relatively minor problem, and that any federal intervention would create delays, complexity and loss to other creditors, the overall view of stakeholders is that this issue should be left to provincial commercial legislation to deal with.

9. GROWTH IN CONSUMER INSOLVENCIES

The issue

During the last two decades consumer insolvencies have risen rapidly. In light of this, stakeholders have pointed out the need to consider introducing further measures in the *BIA* to address this increase.

Background

The number of consumer insolvencies has grown steadily from about 21 000 in 1980 to almost 93 000 in 2001.[8] This is an increase from 1.14 per thousand of adult population to 3.77 per thousand, a 230 percent increase. Consumer bankrupts as a group are not simply a cross section of the population as a whole; they differ in important respects. A larger proportion of insolvent consumers is young. A relatively high

8. Annual Statistical Reports, OSB.

percentage are unemployed or self-employed. Insolvent consumers are also concentrated in the low income categories. While they tend to have few assets and low debts, given their low incomes they have relatively high debt-to-income ratios.

There has been a demographic shift of the population into several of the categories that have been more vulnerable to insolvency, including single parents, self-employed and the unemployed. It has been estimated that the demographic shift into high risk categories and the increased vulnerability of debtors within these categories may account for as much as 40 percent of the increase in bankruptcies.[9]

Per capita real disposable income was somewhat stagnant in the 1990s. During this period, debt levels increased, resulting in steadily rising debt-to-income ratios.

Two amendments that tend to contain the number of insolvencies were enacted in 1992. Mandatory counselling was introduced to increase the debt management skills of debtors and to reduce the incidence of repeat insolvencies. A consumer proposals scheme gave consumer debtors an alternative to bankruptcy.

Another change was made in 1997, when the *BIA* was amended to encourage debtors to take more responsibility for their debts. This change reflected concerns at the time that some debtors were taking advantage of bankruptcy too quickly, using it to rid themselves of debt when they could afford to pay at least some of those debts, either through consumer proposals or outside bankruptcy altogether. The amendments require bankrupt debtors, while they are bankrupt, to contribute income above their basic needs to their creditors. They also require the trustee to recommend whether a bankrupt should not be discharged unconditionally, in light of the debtor's conduct and ability to pay his or her debts partially. The trustee, in preparing the recommendations, and the courts, in deciding whether to refuse a full discharge, are to consider whether the debtor made surplus income payments as required, or could have made a viable consumer proposal rather than go bankrupt. The 1997 amendments also limit access to a fresh start for student debtors, by not allowing a discharge from student loan debts for two years after finishing studies. The non-discharge period was increased to 10 years in 1998 to reflect increased benefits provided for students in that year's budget.

Some intervenors before Parliamentary committees reviewing the 1997 legislation suggested that the amendments were oppressive to debtors and that creditors should also bear some responsibility for high consumer debt levels. In support of these arguments they pointed to strong lender advertising to encourage consumer borrowing and too frequent credit card solicitations.

9. Craig Campbell, *Increased Rate of Personal Bankruptcy in Canada: Socioeconomic Influences (1976–1997)* (unpublished paper prepared for Industry Canada, December 2001).

Considerations

The rise in consumer insolvencies, not just in absolute numbers but on a per capita basis, is a matter of concern to many consumer insolvency stakeholders. Given the recent social trends in Canada — the shift of the population into higher insolvency risk categories — a rise in insolvencies would be expected irrespective of insolvency law provisions. Growing debt levels and growing debt relative to incomes are factors affecting insolvencies that insolvency law may be able to influence.

Growing debt-to-income ratios could have several causes. They could result from changing attitudes of borrowers and lenders to risk, a more tolerant attitude of consumers to bankruptcy, and a lessening of the stigma attached to bankruptcy.

The fresh start provisions of the *BIA* provide essential protection for consumer debtors against financial catastrophe. They also expose lenders to higher risk and may generate moral hazard and adverse selection problems for lenders. The fresh start provisions give lenders the incentive to monitor their debtors. In addition, they give individuals an incentive to plan for their future.

If it is decided that growing debt is a problem and that insolvency law must do more to remedy it, the 1997 *BIA* incentives for debtors to take added responsibility for their debts could be complemented by some creditor incentives. One approach suggested by stakeholders might be to reduce the status in bankruptcy of claims relating to those types of consumer loans that should be discouraged.

Consultations

There was considerable and varied discussion on this issue, ranging from consumer responsibility and lending practices to current economic realities, the social role of bankruptcy law, and the lessening stigma of bankruptcy. While there was no consensus on individual issues, the overall view that did emerge was that this was not something that should be dealt with through insolvency legislation.

The common view was that there are several factors that contribute to the growth in consumer insolvencies and that they are somewhat intertwined. Some factors are of a social nature, which cannot be controlled through legislation; therefore, it would be impractical and unfair to attempt to address specific factors in isolation. Many took the view that while there is growth in consumer bankruptcies, this is not necessarily out of context with the nature of our economy, which is far more credit-based than in the past. It was noted that although credit granting practices may be a concern, these constitute commercial transactions, which are a distinct issue and governed by other legislation, and it may be that insolvency law should not be used as a tool to adjust them. Also noted was that the consumer is as much responsible for the use of credit as the credit grantor is for making it available; therefore, why penalize only one of the parties involved, as one option in the discussion paper proposed.

In fact, it was suggested that perhaps it is the ease with which bankruptcy is possible that is partly the cause, and that the present regime does not do enough to make bankruptcy an unenviable choice unless truly necessary. Some creditors supported this view, noting that their bad debt rate has remained consistent with the amount of credit granted, and suggesting that increased credit is not the root cause of any growth.

10. STUDENT LOANS

The issue

The issue is whether the *BIA* provisions that restrict the ability of bankrupt students to obtain a discharge from their student loan debts for 10 years should be modified.

Background

In 1997, amendments to the *BIA* prevented bankrupt individuals from discharging their student loans if they were still in school or for the first two years after leaving school. These changes were made to help support the sustainability of the Canada Student Loan Program.

During the period 1990–91 to 1995–96, the number of bankruptcies involving student loans increased by more than 73 percent. Also, with respect to the Canada Student Loan Program, losses during that same period increased by 127 percent, from $40.1 million to $91.1 million.[10]

In 1998, as part of the 1998 Budget package, further amendments were made to the *BIA*. These changes provide that where a person with student loan debts goes bankrupt while a student or within 10 years after finishing studies, any outstanding student loan debts and interest owing on those debts will not be discharged by the bankruptcy.

Should a person declare bankruptcy within this 10-year period and still owe money for the student loan at the end of the 10-year period, an application can then be made to the courts to have the remaining student loan balance discharged. To be eligible for this discharge, the applicant must have acted in good faith in respect of the loan and show evidence that financial difficulty will continue to such an extent that it will not be possible to repay the loan.

The 1998 amendments were intended to reflect the very substantial benefits provided to students in the 1998 Budget. These benefits included a new and very large scholarship program (the Millennium Scholarship Fund) under the Canada Opportunities Strategy. The Fund significantly increased non-repayable grants available to students

10. HRDC, Canada Student Loan Program Claims Legacy Files.

and under the Canada Student Loan Program many relief measures were made available to students who received loans. These include:

- a six-month grace period before repayment commences;
- 30 months of interest rate relief over the life of the loan, extendable for another 24 months for students with prolonged financial difficulty;
- potential extension of the amortization period of the loan up to 15 years; and
- potential loan forgiveness of up to $10 000.

The amendments to the *BIA* under the 1998 Budget were intended to ensure that students would take advantage of these generous relief measures before considering bankruptcy. By so doing, the amendments limited the losses on student loans and helped assure the continued availability of student loan funds.

Considerations

A challenge of the student loan provisions on grounds that they contravene the rights of students under the Charter of Rights is currently before the courts. In light of this, no options for changes have been considered.

Consultations

This issue was raised by stakeholders at all consultations, and in Ottawa it was the subject of a brief presentation by a representative of the Canadian Alliance of Student Associations (CASA).

The present rules regarding the discharge of student loans were viewed by most stakeholders as too harsh. Many felt that these loans should not be treated differently than any other loan. The current restrictions were seen by many as unfair, and some found that they did not reflect reality. They suggested that there are indeed many people who, despite their best efforts, qualify as bankrupt, but for whom declaring bankruptcy is of little benefit because their largest debt is a student loan that would not be eliminated.

CASA took the position that there was too little time to assess the success of raising the non-dischargeable period to two years before the period was further increased to 10 years. CASA proposed reducing the period to five years and then evaluating it. Another proposal involved simply making a student loan debt a preferred claim, but one which is still encompassed by the bankruptcy. Other concerns were that the provisions apply to anyone who has not been out of school for at least 10 years, rather than to loans that are at least 10 years old. This provision means that someone who returns to school, without taking new student loans, restarts the 10-year period, even though it could conceivably be for a loan made 15 years ago.

A final concern, although it is beyond the scope of insolvency law, was that loans are readily available for many courses that, in the trustees' experience, seem unlikely to offer the career prospects necessary to be able to repay the student loans.

11. WAGE ASSIGNMENTS

The issue

Some stakeholders, particularly in the financial community, would like to restore the effectiveness of wage assignments.

Background

A wage assignment is a form of security for consumer loans in which the collateral is a portion of the future wages of the borrower. Wage assignments are permitted in Ontario and Manitoba. They may only be used by credit unions.

Before 1992, wage assignments were enforceable against wages earned after bankruptcy and before discharge. Credit unions regularly took wage assignments from borrower members as pledges of up to 20 percent of the wages.

In 1992, section 68.1 was added to the *BIA*, providing that assignments of future or existing wages made before bankruptcy did not apply to post-bankruptcy wages. Ontario credit unions have argued that as a result of section 68.1, other creditors — including credit card issuers, who charge higher rates than credit unions — are receiving money that previously went to the credit unions. They have sought the repeal of section 68.1.

Considerations

A wage assignment may be the only collateral that a debtor has and his or her ability to get a loan may depend on its availability. On the other hand, because the collateral in a wage assignment consists of a substantial part of the future earnings of the debtor, the operation of a wage assignment in bankruptcy may seriously compromise the debtor's chance to get a fresh start. The availability of wage assignments also reduces the amounts available to other creditors in bankruptcy.

Section 68.1, making wage assignments unenforceable, resolves problems encountered with the pre-1992 law. Those problems included strategic behaviour by credit unions trying to extend the period before a bankrupt's discharge while a wage assignment still operated and by trustees trying to advance the date of discharge as much as possible to assist the debtor. Section 68.1 increases the lending risks for credit unions in those provinces permitting wage assignments and may lead to reduced credit availability for credit union member–borrowers. Yet credit unions in other provinces have been able to carry on without the availability of wage assignments. Credit unions in provinces permitting wage assignments seem to have adjusted well to section 68.1. Overall, the effect on credit availability may be small.

Repeal of section 68.1 would reduce a bankrupt debtor's chances for a fresh start. The strategic behaviour problems solved by section 68.1 would return. Other creditors would have less access to the debtor's post-bankruptcy earnings, because surplus income available under section 68.1 would likely fall. On the other hand, lending risks for credit unions would be reduced and credit availability may be increased.

Consultations

There was a large consensus in support of leaving the provisions dealing with wage assignments to credit unions as they are now.

Despite the suggestion that in many cases credit unions differ from traditional lending institutions and often serve areas that would otherwise go unserved, the consensus was that credit unions have the same opportunities as other lenders to share in the proceeds of a bankruptcy and any excess income payments. Stakeholders also noted that as only two provinces allow such agreements, wage assignments would further complicate the system and reduce any return to other creditors through the excess income contribution. Concern was also raised that allowing the practice of wage assignments to survive bankruptcy would encourage credit unions to oppose discharges as a means of extending payments to them.

APPENDIXES

APPENDIX A: RECENT LEGISLATIVE AMENDMENTS

The 1992 changes included:

- making deemed trusts protecting Crown claims ineffective in bankruptcies, other than deemed trusts protecting Crown claims to source deductions of income taxes and Canada and Quebec Pension Plan and Employment Insurance premiums;
- recognizing only those statutory security interests protecting Crown claims that are registered and subordinating those claims to previously registered competing security interests;
- removing preferred creditor status for Crown claims generally;
- imposing an automatic stay preventing secured creditors from realizing on their security in business reorganization proposals;
- introducing a reporting requirement for receiverships, to enable the OSB to gather information on and supervise receiverships;
- introducing a right for unpaid suppliers to reclaim goods within 30 days of delivery;
- implementing a separate regime for consumer proposals;
- protecting trustees against claims for environmental damage; and
- giving the Superintendent of Bankruptcy greater licensing powers.

The major 1997 reforms included:

- improving trustee protection from claims for environmental damage and giving them protection against liability as successor employers;
- giving the Crown a super-priority (that is, a first claim on the debtor's assets) for the costs of any clean-up of environmental damage;

- limiting directors' personal liability during the reorganization of a company;
- introducing rules governing bankruptcies of securities firms and international insolvencies;
- harmonizing elements of the *CCAA* and the *BIA*;
- requiring bankrupt individuals with income in excess of basic needs to make payments to their estates for the benefit of their creditors; and
- further increasing the Superintendent of Bankruptcy's licensing powers.

APPENDIX B: PRIORITY OF CLAIMS

The priority of claims is fundamental to insolvency law. The primary feature of an insolvency is that there is not enough money to satisfy all the creditors. For any number of reasons not all creditors are treated equally; rather they are categorized, with some classes entitled to payment before others. In insolvency, the claims of creditors reflect several different pieces of legislation at both the federal and provincial levels.

The first entitlement to payment are the "super-priorities." A super-priority is a claim which by legislation is put ahead of other creditors, regardless of any contractual right or lesser legislative entitlement. Two super-priorities exist, both in favour of the Crown. The first is for compensation for any environmental damage. The second is for unremitted source deductions of Canada Pension Plan and Employment Insurance premiums, and employee tax withholdings.

Second in line for payment are "secured creditors." Secured creditors may have obtained their security rights through private agreement between the debtor and the creditor (for example, a mortgage loan contract). The secured creditors in these cases will normally protect their prior ranking by registering their security agreements in a recognized registry system. The registries and the priority rules that apply to these security agreements are primarily governed by provincial law. Both the *BIA* and *CCAA* recognize these rules.

After secured creditors come the "preferred creditors," whose entitlement is through legislation; the entitlement applies only in bankruptcy proceedings. Section 136 of the *BIA* governs the distribution of the property of the debtor remaining after the secured creditors have realized on their security. It provides that the proceeds realized from the property of a bankrupt debtor are, subject to secured creditors' rights, to be distributed among nine classes of claims of preferred creditors, ranked in the following order:

1. funeral expenses of the bankrupt
2. costs of administering the bankruptcy (trustees' fees and legal expenses)
3. a levy imposed on all estates to help defray the expenses of the OSB
4. wage claims up to $2000, plus $1000 in salesmen's expenses
5. alimony and maintenance claims
6. municipal taxes
7. landlords' claims for rent
8. costs of the creditor who first executed against the debtor, and
9. claims of workers for injuries not covered by Workers' Compensation.

The claims of creditors in each class are to be paid in full before those with claims in lower classes receive anything.

Any remaining funds after all preferred claims have been paid are to be distributed among the "other creditors" in proportion to their claims. An exception is made for certain types of deferred claims, which have lower ranking. Wage claims of spouses of bankrupts are not paid until claims of other creditors are paid. Wage claims of other relatives of a bankrupt employer do not have preferred status.

In addition, there are special provisions for groups such as unpaid suppliers that do not improve their claim but that provide special rights, such as the ability to repossess goods sold to the debtor.

APPENDIX C: LIST OF SUBMISSIONS

The following stakeholders have made written submissions and have consented to the release of their submissions (provided to the Committee under separate cover).

Barnes, Stephen H., MacKay and Company Ltd.

British Columbia Securities Commission

Canada Customs and Revenue Agency, Government of Canada

Canadian Alliance of Student Associations

Canadian Association of Insolvency and Restructuring Professionals

Canadian Association of Insurance and Financial Advisors

Canadian Banker's Association (2 submissions)

Canadian Real Estate Association

Credit Bureau of Ottawa and Hull

Fédération des caisses Desjardins du Québec

Fiducie Desjardins inc.

Honsberger, John D., Raymond and Honsberger

Insolvency Institute of Canada

Klotz, Bob, Klotz Associates

Masse, Stan

Mauro, Cathy

O'Meara, Marc

Ontario Securities Commission

Owen, John, Omega-One Ltd.

RESP Dealers of Canada

Saskatchewan Labour, Government of Saskatchewan

Steele, Andy, Compaq Canada

Syncrude Canada Ltd.

Toronto Stock Exchange

Ziegel, Jacob

GLOSSARY

These definitions are provided as a simple reference tool for the purpose of this paper only. Formal definitions for use in other situations may exist in legislation.

ASSET ROLLOVER — The commonly used term to describe a situation in which the principals of a bankrupt company purchase assets from the bankrupt corporation to restart the same type of business. The concern is that the principals in effect continue the same business under a new name, while creditors of the bankrupt company suffer a loss. These are occasionally referred to as "flips."

BANKRUPTCY — The legal status of a bankrupt, who is a person who has gone bankrupt under the *BIA*, either voluntarily by making an assignment in bankruptcy, or involuntarily by having a receiving order made against that person.

CONSUMER LIENS — A priority right held by a consumer against assets of a business with whom the consumer has made a deposit or down payment for goods or services that the business has not delivered.

CONSUMER PROPOSAL — A proposal made by a consumer debtor to his or her creditors under Division II of Part III of the *BIA*, with the intention being to restructure the debt. A typical proposal will result in the debtor repaying less than the full debt but more than might occur in a bankruptcy.

CREDITOR — A person, business or corporation with a claim for a debt owed. For the purposes of the *BIA*, a creditor is a person with a secured, unsecured or preferred claim provable under the Act.

DEBTOR — A person, business or corporation which owes a debt to others. A debtor under the *BIA* is a person who resided in Canada or carried on business there at the time of his insolvency.

DEBTOR-IN-POSSESSION FINANCING (DIP) — Financing obtained by a reorganizing debtor, the significant feature being that the lender assumes priority over other existing creditors.

DEEMED TRUST — A statutory priority whereby assets of a debtor are deemed to be held in trust for the specified creditors to whom the priority is granted, and hence are not available for distribution to the other creditors of the debtor. The *BIA* does not recognize deemed trusts giving priority to Crown claims, other than those protecting Crown claims for source deductions of income taxes, Canada Pension Plan and Quebec Pension Plan premiums and Employment Insurance premiums.

INSOLVENCY — This has both legal and accounting meanings, but describes a person, business or incorporation that while not bankrupt cannot meet certain standards of financial viability. The *BIA* defines an insolvent person as one who cannot pay his or her debts as they fall due, has stopped paying his or her debts, or whose assets could not cover his or her debts.

LIQUIDATION — Disposing of assets of the debtor, the proceeds to be used toward paying the debts and obligations of the debtor.

PREFERENCES — Payment by an insolvent debtor to one or more creditors while excluding other creditors. The *BIA* provides that the trustee may overturn certain transfers of property or payments to a creditor by a debtor who later goes bankrupt with the intent of preferring that creditor over other creditors.

PREFERRED CREDITORS — Creditors that do not hold security for the debt owed to them, but that fall into one of the categories identified in section 136 of the *BIA* and are granted a priority over other unsecured creditors.

PRIORITY — The ranking of creditors to determine in which order they may be paid.

REAFFIRMATION AGREEMENT — An agreement by a consumer debtor to reinstate a debt that was erased by bankruptcy or reorganization, usually for the purpose of obtaining new credit.

RECEIVER — A person appointed under the terms of a contract with a debtor or by the court, whose powers are specified in the contract or by the court and may include taking possession or control of some or all assets of the debtor, realizing the assets, and paying the proceeds to the creditor under the contract to the extent of the outstanding debt, or to the creditors generally.

REORGANIZATION — A proceeding under the *CCAA* or Part III, Division I of the *BIA* to restructure a business's debt so that the business may continue to operate. These proposals may typically result in creditors receiving less than full repayment, but more than they would receive in a bankruptcy.

SECURED CLAIM — A claim by a creditor that is secured by assets of the debtor in the event of non-payment.

SECURED CREDITOR — A creditor who holds security — which may be in the form of a mortgage, charge, pledge, security interest under a *Personal Property Security Act*, or other security interest — for the debt owed.

SECURITY — The assets of the debtor to which a secured creditor has entitlement if the debtor defaults in payment.

STAY — In bankruptcy and insolvency proceedings, the suspension by statute or court order of a creditor's ability to exercise a right it would otherwise have to take legal action, including action to collect a debt.

SUPER-PRIORITY — A priority granted by statute that ranks a claim ahead of all other claims, including secured creditors' claims.

TRANSFERS AT UNDERVALUE — The sale of goods by an insolvent person, business or corporation at substantially less than the market value, typically to a non-arm's-length party.

TRUSTEES — A trustee in bankruptcy is a person licensed by the OSB to administer proposals and bankruptcies.

UNSECURED CREDITOR — A creditor who has loaned money or provided goods or services to a debtor without securing the debt through some form of security agreement against debtor assets.

WAGE ASSIGNMENT — The commitment of a portion of a person's future earnings as security for a loan or credit.