

# INSOLVENCY GROUP NEWS

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**Book Review**

***‘The Bankruptcy and Insolvency Act of Canada, A Creditor’s Perspective’***

Bruce Copeland, author of *The Bankruptcy and Insolvency Act, A Creditor’s Perspective*, has provided an interpretation of *The Bankruptcy and Insolvency Act* (“BIA”) that is easy to read and succeeds in simplifying the bankruptcy and restructuring process. For the most part the book uses laymen’s terms instead of ‘legalese’ to explain the legislation and its impact on creditors.

The book highlights the roles of the various persons involved in the bankruptcy and insolvency process such as the debtor, creditor, trustee, receiver, lawyers, the Office of the Superintendent of Bankruptcy, the Official Receiver, the Registrar and the Court.

The book provides a good introduction to the BIA and the Insolvency process. It provides creditors with helpful tips while wading through the bankruptcy process. In particular it addresses creditor’s rights and presses creditors to ensure that their interest is

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***Non-Financial Warning Signs***

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With 80% of North American companies being privately-held, financial information is often not available and credit grantors must rely on non-financial information in order to make their credit decisions. Without the use of financial parameters or ratios how can these professionals evaluate the solvency of their customers? In this article we will present some non-financial indicators of financial problems, which when detected early can lead to a happy ending for all concerned. These indicators fall into the following categories: Payment Patterns, Purchasing Patterns, Industry Trends, New Developments, Lawsuits, Personal Problems, and the Rumour Mill.

**PAYMENT PATTERNS**

Companies typically pay invoices on a regular, albeit sometimes on a tardy basis. Any change in this pattern should be a red flag to creditors and could be an indicator of financial and cash flow problems. These changes include a company no longer taking advantage of discount terms or a company extending its payment terms. For example, in

the fall of 1996 privately held T. Eaton Company Ltd. extended its standard 75 day payment terms. The Company filed for Protection under the Companies Creditors Arrangement Act (“CCAA”) in February 1997.

**PURCHASING PATTERNS**

Are your customer’s orders increasing or decreasing? A decrease in purchases may indicate that a customer’s sales are declining or that the customer has found another supplier. If a customer has reached its credit limit and the account is overdue, a decrease in purchases may suggest that the customer is unable to meet its liabilities and is unfortunately increasing its credit by purchasing from another supplier. Is your customer purchasing a higher number of smaller orders? This could indicate that a customer does not have sufficient cash flow to pay for larger orders. A sudden increase in purchases is also suspicious if there is no evidence that the customer is experiencing an increase in business. Maybe the customer is stockpiling inventory prior to a Court Restructuring.

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Expand 30 Day goods rights?  
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*Non-Financial Signs Continued from Page 1***INDUSTRY TRENDS**

What are the industry trends and how do they affect your customer? Have technological advances negatively impacted your customer? Is your customer in danger of losing market share due to new technology? Are your customers adversely impacted by changes in the industry or the economy in general? The auto industry is one of the primary customers of the steel mills. A downturn in automotive sales will impact not only the automotive industry but will have a domino effect on their suppliers whether they are original equipment manufacturers, the second tier suppliers, the after market manufacturers as well as businesses in the surrounding areas.

Continuing with the steel industry analogy, companies must be aware of the impact of imports and dumping on its customers. Essentially, companies need to know their customer portfolios and must be able to pinpoint their weaker customers. These customers will be the ones most deeply effected by an adverse change in the industry. These are the customers that companies need to monitor closely and where necessary cull from their portfolio.

**NEW DEVELOPMENTS**

How well do you know your customer? Where is your customer located? Has a strong competitor recently moved into your customer's territory? The advent of Big Box stores has eliminated many local and weaker national companies. We have all seen the impact of Home Depot, Wal-mart and Chapters on weaker competitors. Being aware of such a development will enable a credit grantor to proactively deal with the situation and determine whether it will continue to support this customer.

**LAW SUITS**

Is your customer the defendant in a major lawsuit or a large number of

lawsuits? How would the loss of such a lawsuit impact your customers' business? Many companies such as Dow Corning Corporation and Texaco Inc. filed for court protection following a large judgement against them relating to some litigation. Credit reports from credit information providers such as Equifax provide a list of outstanding litigation, giving a 'heads up' to credit grantors.

**PERSONAL PROBLEMS**

Is your customer experiencing personal problems? Is the owner or majority shareholder involved in a divorce? Is the owner experiencing health problems? Is there a succession plan? Owners or key personnel may be distracted by personal problems and lose focus on the business. An owner may be forced to give up a part of his business in the event of a divorce or incur additional debt in order to make a lump sum payment to a spouse. Either of these events may adversely impact a business. Being aware of such matters would enable a credit grantor to closely monitor a customer's account for signs of deterioration.

**RUMOUR MILL**

The old adage "where there's smoke there's fire" is typically on the mark. If there are rumours that a customer is experiencing financial difficulties or cash flow problems, there is probably some truth to the rumours. A credit grantor would be wise to investigate the rumours and monitor the account closely.

**THIRD PARTY ENDORSEMENT**

Credit grantors can use credit reports or Bank reports as a source of non-financial information about its customers. These reports provide trade payment information, the number of years in business and other relevant information. Some of these agencies also offer

monitoring services, which could assist credit grantors in detecting any financial deterioration in their customers.

**Summary**

Current financial information is the best indicator of commercial distress. However, when financial information is not available, a credit grantor must rely on other information as a bellwether of customer problems. Customer and industry knowledge are important non-financial data, which a credit grantor can use to detect impending financial problems ?

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recognized and more important, that their claim is provable in the bankruptcy.

There are a couple of areas in the book that require further clarification, specifically:

**1. Section V, paragraph 2e) Creditor's Meeting**

"The Trustee will call a meeting of all creditors to consider and vote on the proposal. The creditors must be given 21 days notice of the meeting, and it must be held within 21 days of the proposal's filing."

Rule 6(2) b of General Rules Under the Bankruptcy and Insolvency Act stipulates that creditors must be given at least 10 days notice of the meeting and not the 21 days referred to in Copeland's book.

**2. Section V, paragraph 3i) Annulment of Discharge of the Proposal**

"There are situations where a consumer proposal may be annulled by the court, for example .....where the proposal is either approved or deemed approved by the court and the terms of the proposal do not provide for the distribution of available monies at least once every three months."

The author describes the situation which applies to instances where the debtor is required to make payments under a Consumer Proposal on a monthly or more frequent basis.

Under Section 66.31(1) (b), if payments under a Consumer Proposal are required to be made on a less frequent basis and the debtor is more than three months in default on any payment, the consumer proposal may be annulled by the court.

**3. Section VI, paragraph 3b) Secured Creditors**

"The Act affects the rights of a secured creditor in several ways...if the value

of the security is less than the debt owed, the creditor is allowed to receive a dividend for the balance" Section 128(2) of the *BIA* states that if the value of the security of a secured creditor is less than the amount of the debt owed, the secured creditor can file a proof of claim as an unsecured creditor for the balance. It will share pro rata in any dividend paid to unsecured creditors. There is no requirement that the secured creditor be paid for its shortfall prior to the other unsecured creditors. The secured creditor has the same ranking as the other unsecured creditors for the shortfall.

**4. Section VI, paragraph 3d) Thirty Day Goods**

"This is a special priority available to suppliers under the Act, section 81.1, allowing them to repossess their goods, at their expense, in a bankruptcy or receivership. This priority is subject to the following conditions:....the goods were delivered in the 30 days prior to the suppliers required written demand in the prescribed format to the receiver or trustee."

The author's point is correct however for further clarification, the supplier must send a written demand to the receiver or trustee requesting the return of his goods within 30 days of shipping the goods to the debtor. Reclaimable goods are those shipped in the past thirty days, not thirty days prior to the bankruptcy. If the supplier shipped goods on day 1, the debtor declared bankruptcy on day 25 and the supplier received notice of the bankruptcy on day 31, six days after the bankruptcy occurred, the supplier would not be able to reclaim the goods.

**5. Section VI, paragraph 3f) Landlord's Rights**

"...the landlord is entitled to a

preferential claim over any surplus assets on the property for a maximum of three months arrears preceding the bankruptcy and up to three months accelerated rent after bankruptcy."

The author is correct, however under section 136(f) of the *BIA* landlords can only claim accelerated rent if there is a provision for such payment in their lease.

**6. Section VII, paragraph 1 Duties Imposed on the Bankrupt**

"Bankrupt debtors' duties include:.....preparing and submitting to the trustee, within seven days of bankruptcy a properly sworn statement of affairs...."

Section 158(d) of the *BIA* stipulates that the bankrupt, being a corporation, must submit the sworn statement of affairs to the trustee within five days of the bankruptcy.

**7. Section IX, Exempted Property, paragraph 2.**

The exemptions in the Province of Ontario were changed effective April 15, 2001.

**8. Section X, Settlements, paragraph 2**

"If the bankruptcy takes place within five years following the initial date of bankruptcy, the settlement may be set aside if the trustee can prove that, within that time, the debtor was unable to pay all the debtor's debts without the property in question."

According to section 91(2) of the *BIA* the settlement can also be set aside if the trustee can prove that the interest of the settler in the property did not pass on execution of the settlement. Hence, if the debtor transferred his cottage in a non-arms length transaction and continued to use the cottage as if he owned it, this transaction would be reviewable and could be set aside.

**Book Review** *Continued from Page 3*

In summary the author has successfully transformed the *BIA* legislation into a user-friendly handbook. The need for clarification on some aspects of the handbook demonstrates the value added by an experienced insolvency professional. Trustees and turnaround professionals are well-versed in the nuances and applications of the *BIA*. They are a valuable resource during a bankruptcy or court restructuring.

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**Consensus Reforms – Q1' 2001**

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The Equifax National Insolvency Group ("NIG") met in Toronto on February 7, 2001 to discuss various issues relating to the Canadian insolvency regime and potential areas for reform. This paper records the consensus that developed on several reforms thought necessary to better protect the rights of suppliers to an insolvent business.

**I. REFORMS TO REPOSSESSION RIGHTS**

The 1992 amendments to the *Bankruptcy and Insolvency Act* (the "BIA") included the addition of a section which was intended to safeguard the rights of suppliers to an insolvent business by extending them certain limited rights of repossession of goods sold. In the result, new section 81.1 provides a limited right for unpaid suppliers of goods to a purchaser that is bankrupt or in receivership to repossess the goods delivered. This right is frequently referred to, by way of shorthand, as a "30 day goods rights".

**(a) Timing of 30 Days Goods Rights**

Section 81.1 is structured so that a prescribed form of written demand for repossession of goods must be presented to the purchaser, trustee, or receiver within a period of 30 days after the delivery of the goods to the purchaser. The onus is on the supplier to monitor each of its customers for the 30 days after goods are supplied to determine if a receivership or bankruptcy occurs.

While the BIA requires that trustees and receivers provide notice of their appointment, suppliers are concerned that in many instances notice of a receivership or bankruptcy is not received until the supplier's rights under section 81.1 have expired. It is conceivable, for example, that a receiver could be appointed in respect of a debtor 20 days after the supplier supplied goods to that debtor and notice of the receivership will not be received until after 30 days from the time that the goods were delivered. The result is that the unpaid supplier has lost the benefit of the rights afforded by section 81.1 of the BIA.

The NIG accordingly recommends that the BIA be amended to provide that a suppliers' 30 days goods rights apply to goods shipped to the debtor in the 30 days immediately preceding a receivership or bankruptcy. The NIG further recommends that the onus be placed on the trustee or receiver to identify goods which may potentially be subject to 81.1 rights and to notify the supplier that such rights may exist.

**(b) Clarification of Unpaid Supplier's Rights**

Suppliers are strongly of the opinion that section 81.1 repossession rights are in need of simplification and clarification in terms of their threshold requirements for operation.

The BIA requires, for instance, that at the time when the prescribed section 81.1 demand is presented the goods at issue must be, among other things, "identifiable as the goods delivered by the supplier" and "in the same state as they were on delivery". These statutory requirements are widely perceived as imposing an unfair evidentiary burden on suppliers while at the same time providing unscrupulous debtors with a mechanism to frustrate a suppliers' rights under the section.



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As these and the other requirements of the section are strictly applied, even suppliers who serve notice on time may find themselves effectively deprived of their rights by virtue of the way in which the purchaser (or the receiver or trustee) has dealt with the goods following delivery.

The consensus of NIG conference attendees was that section 81.1 should be simplified and made more practical and less onerous on suppliers. Receivers, trustees and debtors could, for example, be statutorily required to take steps where at all possible to identify, segregate and preserve goods subject to section 81.1 rights and to provide notice of those rights to suppliers.

### **(c) 30 Day Goods Rights in a Reorganization**

The rights conferred by section 81.1 of the BIA can only be exercised if the debtor is bankrupt or a receiver has been appointed. They are not applicable where a debtor has filed a proposal pursuant to Part III of the BIA or commenced a *Companies' Creditors Arrangement Act* ("CCAA") reorganization.

This important limitation on repossession rights creates a situation where suppliers often indirectly finance the company through a reorganization as the company uses the proceeds from its inventory without paying their suppliers.

The NIG believes that the suppliers supplying goods to a debtor in the 30 days period immediately preceding the commencement of a reorganization ought to receive preferred status for claims arising from such supply. Specifically, the NIG recommends that provisions be added to the BIA and the CCAA which require any Proposal or Plan of compromise or arrangement to include provisions which provide for the payment of all obligations relating to the supply of goods in the 30 days immediately preceding the commencement of the reorganization within the six months immediately after the approval of the Plan or Proposal by the Court. Similar provisions currently exist in respect of Crown claims and employee claims.

## **II. REFORMS TO REQUIREMENT TO SUPPLY TO A REORGANIZING DEBTOR**

Section 65.1 (1) of the BIA provides that where a debtor has filed notice of its intention to make a proposal, no person may terminate or amend any agreement with the debtor or claim an accelerated payment under any agreement with the debtor, by reason only of the fact that the debtor is insolvent. This, in effect, requires a supplier doing business with, and owed money by, a company that announces its intention to reorganize to continue to deal with the insolvent debtor.

Similarly, in CCAA reorganizations, persons with the agreements with the debtor, including supply agreements, are stayed by Court Order from terminating or amending their agreements. This generally means that the suppliers are required to continue to supply goods and services to the debtor while the debtor attempts to develop a Plan.

Both the BIA and the CCAA permit suppliers to require the immediate payment for goods and services and do not require suppliers to extend further credit to the debtor.

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*NIG Consensus* *Continued from Page 5*

Neither Act goes so far, however, as to protect suppliers in the event that the debtor's attempt to reorganize is not successful and a bankruptcy or receivership results. Any amounts owing to suppliers for goods and services apply to the debtor during a failed reorganization attempt rank as ordinary unsecured claims in the receivership or bankruptcy.

Problems arise when suppliers quite reasonably place reliance on the reorganizing debtor's advice that it is operating under the protection of the Court and the supervision of a court appointed "monitor" of its business and affairs. Suppliers are frequently lulled into a false sense of security that because the debtor is not bankrupt they can continue to deal on a business as usual basis. In other cases, even where creditors are aware of their rights to require immediate payment for supplies, it may not be practical for them to manage significant deliveries of inventory to multiple locations on a cash on delivery basis.

The claims of post-filing suppliers to a reorganizing debtor have been considered in several recent Canadian cases and, in each case, the suppliers' claims were fully subordinated to the rights of secured creditors and the suppliers went unpaid.

In *561861 Ontario Ltd v. 1085043 Ontario Inc.* unpaid suppliers of services to a reorganizing debtor were told that it was incumbent upon them to make sure that they were properly remunerated and that they had no statutory protections for payment for their services even though the services clearly benefited the debtors' reorganization. An identical conclusion was reached in *Pike v. Bel-Tronics Co.*, where the court considered the claims of post-filing suppliers of goods and services and concluded that they should be filed and dealt with through the normal claims process in the bankruptcy.

The NIG believes that such creditors should not be adversely affected having been required to supply to the debtor in many instances against their will. The NIG recommends that provisions be added to the BIA and the CCAA which provide that any claims arising as a result of the supply of goods and services in a reorganization be paid in priority to the claims of all of the creditors, including secured creditors.

### **III. INCREASED REPRESENTATION THROUGH CREDITORS' COMMITTEES**

There are no provisions in the CCAA or the BIA which authorize or mandate the creation of creditors committees as is the case in restructuring proceedings commenced under the United States Bankruptcy Code.

The concept of mandating a requirement and a role for committees of unsecured creditors in a Canadian reorganization received broad support amongst NIG conference attendees.

Very generally, the idea would be to require a reorganizing debtor to afford unsecured creditors with an opportunity to organize themselves into a representative body that could, among other things, receive information and inform itself, act as a conduit for information to creditors generally, and take positions on important issues in the reorganization. It was suggested that the committee might be made up of the six or seven largest unsecured creditors with a declared interest in participating. The idea of electing creditors to serve at a meeting of unsecured creditors also received some support providing that creditors could participate by proxy or by telephone.

### **IV. DEBTOR'S AUDITOR AS MONITOR IN A CCAA REORGANIZATION**

The 1992 amendments to the CCAA require the appointment of a person with broad powers to monitor the business and financial affairs of the debtor company during the court ordered stay of proceedings. Section 11.7(2) of the CCAA provides that "except as may otherwise be directed by the Court" the debtor's auditor may be appointed as monitor in a CCAA proceeding.

The provision to allow auditors to act as monitor continues to draw criticism. The equivalent is not allowed in a BIA restructuring and there is wide spread concern on the part of suppliers with respect to a perceived lack of independence on the part of auditors acting as monitors.

The concern is that the appointment of auditors as monitor may result in real or perceived conflicts of interest that serve to undermine supplier confidence in the debtor, the monitor, and the restructuring process generally. In this regard it is noted that auditor / monitors have fiduciary duties owing to the creditors that may be impaired by their strong historical connections to and dependencies on the continued survival of the debtor. The consensus opinion of suppliers was that the creditors interest in having a monitor perceived as independent will usually outweigh any efficiencies that might be realized from having a debtor's auditor step into the role of monitor and the Act should be amended accordingly.