Failure to Capture the Brass Ring:

An Empirical Study of Business Bankruptcies and Proposals under the Canadian *Bankruptcy and Insolvency Act*

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EXECUTIVE SUMMARY

This study is an empirical and qualitative analysis of both business bankruptcies and proposals in Canada from 2005-2008, examining data from over 6,000 files. The objective of the research was to gain a deeper understanding of the types of businesses that fail, the underlying causes, and the mechanisms available under the *Bankruptcy and Insolvency Act* to address the insolvency. A working hypothesis of the study was that there are multiple causes of business failure, some of which relate to the experience and skills of the principals of the business and some of which relate to more general economic conditions that are beyond the control of individual directors and officers. A second working hypothesis was that the nature of debt may be changing, such that businesses are facing greater challenges than previously in their credit relationships. A clearer understanding of the causes and solutions to business insolvency may assist in designing improvements to the insolvency system.

Public policy should generally be aimed at encouraging business innovation and entrepreneurship, and thus insolvency policy should be aimed more directly at encouraging business proposals and supporting restructuring when firms are financially distressed but otherwise viable. It is the existence of a timely and cost-effective insolvency system that encourages individuals to start companies, take measured risks to commence and expand businesses, and generate economic activity.

In terms of causes of business failure by type of business, the data overall suggest that for incorporated businesses, poor management, insufficient business revenue, over-extension of credit and downturn in the economy are four significant causes of insolvency. However, larger businesses that file under the *BIA* are more likely to have effective governance structures in place. For sole proprietorships, poor management or money mismanagement is a very significant cause of financial distress, with almost three quarters of trustees observing that this factor played a significant role in the insolvency. Other significant causes were overextension of credit, under-capitalization of the business, downturn in the economy and failure to pay taxes. For partnerships, the causes tracked those of sole proprietorships to some extent, suggesting that the same kinds of challenges face partnerships as for businesses operated by single individuals. Under-capitalization was a significant cause of insolvency, as was overextension of credit. There were numerous instances in which business debtors listed more than one cause of insolvency. It is impossible to measure the synergistic effects of these multiple causes, but they must be borne in mind when examining specific primary causes of insolvency.

Recent data in late 2008 and early 2009 indicate that the global economic downturn is rapidly becoming a primary cause of business insolvency and businesses that would otherwise be viable are having difficulty accessing bridge financing. The financial distress of large manufacturers, such as in the auto industry, is having a significant ripple effect on auto parts suppliers and other related businesses, creating cascading financial distress.

The study found that a principal cause of business insolvency is poor management across all categories of incorporated entities, partnerships and sole proprietorships. Of the 702 filings in the 5,515 data set that had detailed information, one-third reported poor management of the business as a principal cause of insolvency. The more detailed data suggest that it is not just poor management of accounts, but failure to have a realistic business plan, to plan for foreseeable contingencies, and

in many cases, the comingling of business and personal debt, which in turn can jeopardize other family as well as the individual business person.

The OSB could offer guidelines that assist small business to revise business plans before they reach the point of insolvency or could make grants available for small and medium enterprises to employ financial expertise. One recommendation that can be clearly drawn from the data is the need for considerably more education and skills building in the area of small business management. The study explores a number of strategies to address this problem. The data also suggest that creditors could be more diligent in their monitoring, such that insolvency risk does not unnecessarily deepen as the debtor experiences various challenges to its finances.

A second major cause of business insolvency was inadequate capitalization of the business. In terms of sole proprietorships, it is evident from the data that businesses are often commenced with considerable skills of the person but inadequate capitalization. For partnerships and corporations, capitalization at commencement of the business appears to be less problematic, and under-capitalization appears to occur when the business decides to expand or move its activities in a different direction and adequate capital is not raised. When a partnership breaks up, if one or more partners wish to carry on the business, often the costs of buying out the exiting partner or partners results in the business becoming under-capitalized. Even companies that are sufficiently capitalized may not have made bridge financing arrangements for a deep and sustained financial downturn such as being experienced in 2009.

Overextension of credit is also a significant factor in respect of business insolvency, both in terms of the degree of leveraging from bank and other operating and capital loans, and credit card usage. The large data set revealed that 24% of business debtors reported over-extension of credit as a significant contributing cause. Credit card debt is particularly a factor in failure of smaller businesses, with average credit card debt of 19,795 CAD, and the median amount of credit card debt 7,000 CAD. The data suggest that businesses incur considerable credit card debt in the period leading up to insolvency filing, frequently being used to cover expenses when revenues declined and the value of receivables outstanding increased. Loans from individuals comprise a significant source of debt, primarily for sole proprietors, often from family and friends. Taxes owing comprise a significant source of debt, with an average of 41,477 CAD. However, the median amount was only 3,520 CAD, suggesting that there are fewer business debtors that owe a significant amount of taxes.

Even though most of the period studied was prior to the current financial crisis, 10% of business debtors reported that an economic downturn in their sector or the economy was a factor in the insolvency. This figure is rapidly rising in 2009. There are two types of challenges faced by businesses. Temporary market shifts require the business to have a strategy to survive the period, including access to bridge financing. Permanent market loss requires an assessment of whether the business can shift the core of its activities to meet new market demands, using credit to enable it to shift those activities, or whether it is more appropriate to wind it down. In periods of market crisis or general economic downturn, credit is tighter and more costly at precisely the time that business may particularly need to access credit to weather the economic downturn. Business insolvency is likely to rise as the ripple effects of a credit freeze begin to manifest themselves in the real economy. This effect appears evident in cases filed in the last quarter of 2008, where market failure begins to enter the reasons for insolvency in a noticeable manner.

While the terms of compromise or arrangement for *BIA* proposals are reported, there is little to link how the terms remedy the cause of the business debtor's insolvency. This lack of transparency and linkage has two implications. First, it is unclear that creditors are given a sense of how their compromise is going to address the underlying causes of the insolvency. Given that they must determine the amount of compromise that they are willing to agree to, whether as employees, operating lenders or trade creditors, creditors need to have a better understanding of whether the company should be liquidated in order to maximize firm value or whether there is merit in the proposed compromise or arrangement. The study indicates that the most significant point of failure is creditor refusal to support the proposal, with a 31% failure rate for business proposals due to lack of creditor approval.

The study identified a number of gaps in data collected by the OSB, identified throughout the report. Enhancement of data collection could serve to assist in making the links between cause of financial distress and strategy to remedy it. For example, in terms of causes of insolvency, the data could be collected in a "drop-down" electronic list that offers more detail in respect of causes, with space to report how the proposal addresses the particular cause. Better identification of the causes of the insolvency for creditors, registrars and the courts would allow for more effective assessment of the proposal. Creditors may be more engaged and involved in the workout strategy if they can fully appreciate the source of financial distress such that the proposal strategy could have greater possibility of a recovery that promises more than just a marginal improvement over that available in bankruptcy. There is a need to link business proposals more directly to the source of distress, including governance, market and other factors, both to encourage a higher degree of creditor confidence in the proposed strategy and to help ensure that the outcome of the proposal truly addresses as many of the causes as possible.

The founding and operation of a business, whether a sole proprietorship, partnership, or incorporated business, is a "grab at the brass ring", in the sense of resources deployed, governance skills, business acumen, cogent business plan, ability to raise capital, market timing, and overall economic climate. The study offers several policy options that address some of the causes of business insolvency identified. These options are assessed on the basis of the potential efficacy, practicality, and conformity with legal and social norms concerning insolvency policy. Finally, the potential effects on business restructuring of the pending amendments to insolvency legislation are briefly reviewed. The study suggests the need for enhanced disclosure to creditors and new skills for debtors to better alert debtors to the most significant systemic risks, such that more realistic choices are made early in the decision process, in turn, enhancing insolvency outcomes.

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TABLES AND GRAPHS

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For some months I have been endeavouring to keep [the debtor] in business and to assist it in making a fair and realistic plan…
Mr. Justice Lloyd Houlden
Ontario Court of Justice General Division
22 April 1992[1]

I. INTRODUCTION

The Canadian insolvency law regime addresses business financial distress by offering rehabilitation through its proposal provisions, which provide a mechanism for restructuring of debt and other workout arrangements, and through its bankruptcy provisions, which offer a timely, fair, and efficient mechanism for liquidating businesses where they are not financially viable, distributing the value of assets to creditors.

Business failure has been occurring for hundreds of years, for reasons both internal and external to the particular business. In some instances, inappropriate use of credit, managerial slack or self-dealing leads to the insolvency of the business, and there is a good case for ending that business activity and moving capital elsewhere. In this respect, some scholars have described insolvency as the creative force of capitalism, in that businesses that are inefficient are liquidated and the capital put to higher and more productive uses.[2] In other cases, business insolvency is due to factors beyond the debtor's control. It may be due to temporary market shifts or more permanent economic conditions, many of which, being unforeseeable, were not subject to contingency planning. Where temporary economic downturn negatively affects an otherwise viable business, it makes sense to devise strategies to allow the business to continue to operate through the downturn, preserving economic activity in the longer term. For medium and longer term economic or financial shocks, such as in 2009, the best business plan may not be sufficient to salvage a business when entire economies are suffering the effects. There are cogent public policy reasons in such a case for offering businesses a mechanism to bridge financial crises or wind-up businesses in a manner than causes the least harm to creditors, employees and others with an economic interest in the businesses.

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[1] 33 A.C.W.S. (3d) 69, Action No. B378/91, Ontario Court of Justice General Division.

[2] Thomas Jackson, "Translating Assets and Liabilities in the Bankruptcy Forum", in J.S. Bhandari and L.A. Weiss, eds., *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge, Cambridge University Press, 1994).

Yet other cases can be viewed almost as "operator failure" in that managerial conduct is well-intentioned but inefficient, with poor management or unviable business plans. In these cases, the question is whether the business should be liquidated or whether there are alternative strategies that can address deficiencies in the business, but allow it to continue to eventually become viable.

Grabbing for the brass ring was a game that originated in the 1880's when carousels were a popular form of children's entertainment. Riders on the outside row of horses on the carousel were given the challenge of trying to grab a brass ring, among many iron rings, as the carousel went by it. Skill, timing and acumen were required. Capturing the brass ring was the ultimate prize. As a cultural reference, to "grab the brass ring" has also denoted striving for the highest prize or goal, the expression found in dictionaries as far back as the late 1800s.[3] The expression came to have the figurative sense of an objective, in particular, one that was hard to achieve. Arguably, the founding and operation of a business, whether a sole proprietorship, partnership, or incorporated business, is a grab at the brass ring, in the sense of resources deployed, skills utilized, business acumen, cogent business plan, ability to raise capital, market timing, and overall economic climate.

In Canada, more than 7,000 businesses fail each year and are forced either to restructure or liquidate their assets under the *Bankruptcy and Insolvency Act (BIA)*.[4] Yet there has been limited research nationally into the causes of business failure and the particular challenges faced by small to medium sized businesses. This study undertakes empirical examination of business insolvency under the *BIA*, in an effort to discern the causes of financial distress, the nature, type and quantum of debt, and the differences in treatment of insolvency for sole proprietorships, partnerships, and corporations. It examines whether the *BIA,* as currently framed, provides the optimal framework for dealing with commercial financial distress, including whether the proposal provisions of the *BIA* truly support rehabilitation of businesses.

In Canada in 2008, the number of new insolvency cases filed with the Office of the Superintendent of Bankruptcy (OSB) increased by 13.2% to 123,234 over the previous year.[5] Of those filings, 7,445 were business insolvencies, a decline of 2.2% from 2007. In 2007, the 7,612 business insolvencies included 5,125 sole proprietorships and 2,499 involved corporations, including partnerships.[6]

Of total business insolvencies in 2008, 6,164 filed bankruptcy proceedings. Business bankruptcies include corporate and non-corporate businesses. "Non-corporate business" includes individuals whose debts are 50% or more related to the operation of a business.[7] Of the remainder of business insolvencies in 2008, 1,281 were filed as proposals, a decline from 1,319 from the previous year.[8]

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[3] Christine Ammer, *The American Heritage Dictionary of Idioms*.

[4] *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (*BIA*). Businesses can be liquidated outside of the *BIA*, including under private receiverships. This study deals only with proceedings under the *BIA*.

[5] Office of the Superintendent of Bankruptcy (OSB), *Insolvency in Canada in 2008,* at 2. OSB, *Annual Report, 2007*, http://strategis.ic.gc.ca/epic/site/bsf-osb.nsf/vwapj/annual-report2007.pdf/$FILE/annual-report2007.pdf.

[6] While technically, a partnership does not need to be incorporated, the OSB reports partnership insolvency under its corporations figures, Stephanie Cavanagh, OSB, correspondence, June 2008.

[7] OSB, *An Overview of Canadian Insolvency Statistics to 2006,* *http://strategis.ic.gc.ca/epic/site/bsf-osb.nsf/vwapj/Statsbooklet2007-*

Hence, a sizeable number of businesses in Canada each year fail to "capture the brass ring" and are forced either to restructure or liquidate their assets. Notwithstanding the large number of business proposals and bankruptcies each year, little is known empirically in respect of the causes of insolvency.

As with many jurisdictions, in Canada, the *BIA* provides debtors or their creditors with an opportunity to liquidate the business in an orderly manner. For individuals involved in a business, it offers them a "fresh start" in that they can begin to rebuild their finances after bankruptcy discharge. For incorporated businesses, bankruptcy may mean an end to a business, with assets liquidated to satisfy creditors' claims, or the business can be sold as a going concern as part of the liquidation, offering a means of rehabilitation under new owners and managers.

The *BIA* also allows businesses to make a proposal as an alternative to bankruptcy and liquidation. A proposal is an arrangement with creditors for a compromise of liabilities, a revised schedule for payment or other arrangement that allows the debtor to work out its financial distress. The *BIA* proposal provisions offer debtors the opportunity for a fresh start through the mechanism of making a proposal to their creditors for payment of their debts, but on terms that allow them to rehabilitate their financial status.[9] The *BIA* proposal proceedings are used for all sizes of business, from sole proprietorships, to partnerships, to corporations. Proposals can be made under the Division I proposal provisions of the *BIA* or under the Division II consumer proposals provisions where 50% of the debts are business related.

Unlike the *Companies' Creditors Arrangement Act (CCAA)*,[10] which has received considerable scholarly attention in recent years, commercial insolvencies and workouts under the *BIA*, particularly for small and medium enterprises (SMEs), have not been the subject of extensive research. While there are many definitions of SMEs, Industry Canada most frequently uses a combination of number of employees and revenue to define them.[11] Yet in the insolvency context, Industry Canada does not collect number of employees or revenues as a measure in its

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EN.pdf/$FILE/Statsbooklet2007-EN.pdf. Consumer bankruptcy captures individuals whose debts are 50% or more related to consumer expenditures.

[8] *Insolvency in Canada in 2008, supra*, note 5.

[9] Another restructuring mechanism in under personal property security legislation, whereby the creditor repossesses the security and assumes the assets in satisfaction of debts and then places the assets into a new entity, and settling, acquiring or shedding other liabilities; see for example the default and possession provisions under the Ontario *Personal Property Security Act*, R.S.O. 1990, c. P. 10, at ss. 62-63.

[10] *Companies' Creditors Arrangement Act,* R.S.C. 1985, c. C-36, as amended (*CCAA*).

[11] A variety of definitions exist for the Small to Medium Size Enterprise (SME) market; generally, these definitions are based on total annual sales, total value of capital assets and / or number of employees. Industry Canada often defines SMEs to include up to 500 employees and annual sales of less than $50 million. Industry Canada, *Key Small Business Financing Statistics - August 2005 What is an SME?,* http://www.ic.gc.ca/eic/site/sme_fdi-prf_pme.nsf/eng/01256.html. Industry Canada observes that "There are many definitions of SMEs, which can be categorized by size according to the number of employees, the value of annual sales, annual revenues or borrowing capacity. This report defines SMEs in terms of number of employees and annual revenues. This definition is fairly consistent with other definitions of SMEs around the world. The European Union (EU) defines SMEs as enterprises that employ fewer than 250 employees and have an annual turnover not exceeding €50 million (C$79 million), and/or an annual balance sheet total not exceeding €43 million (C$68 million)".

insolvency statistics through its office of the Superintendent of Bankruptcy; rather, assets and debts are the defining indicia. For purposes of this study, we examined an overall sample of files under the *BIA* without arbitrarily limiting the cohort to a specified level of debts or assets. The study found, however, that of the 5,515 files examined, most businesses that use the *BIA* bankruptcies or proposal procedures have less than $1 million in assets and less than $2 million in liabilities.

There has never been a national empirical study on commercial insolvency under the *BIA,* and there have been few regional studies. A study by Professors Ziegel and Davis in the early 1990's reported on returns to unsecured creditors in 90 Toronto bankruptcies. Another, by Professors Papillon and Gosselin in 2005 examined reorganization issues in Montréal and Québec City from 1998 to 2003, studying 13 *BIA* and 7 *CCAA* files in depth.[12] They, with colleague Sébastien Deschênes, also examined the potential effect of statutory terms of financing for small and medium enterprises in 2007.[13]

This research project is aimed at further advancing the scholarship through empirical study of business insolvency under the *BIA*. The research was conducted under the Canadian Insolvency Foundation Fellowship in the name of The Honourable Lloyd W. Houlden.[14] Mr. Justice Houlden is the "senior senator" of Canadian insolvency law, having served on the Ontario superior court from 1969 to 1974 and on the Ontario Court of Appeal from 1974 to 1997. While on the appellate court, he continued to sit as a trial judge on major insolvency restructuring proceedings.[15] During his tenure on the Ontario Court, Justice Houlden cared deeply about the efficacy and fairness of the Canadian insolvency system. As a Doctoral candidate in law in 1998 who met with Justice Houlden, I deeply appreciated his sharing his insights regarding corporate restructuring in Canada and his expressed support of my project to highlight the public interest aspects of commercial insolvency law. Ten years later, it is an honour to hold the Honourable Lloyd Houlden Fellowship, and to recall his many contributions to insolvency law during the research and writing of this project.

Part II explains the scope and objectives of the study, and the research methodology, including the limitations of the data analysis. Part III sets out the legislative framework, providing a brief overview of the options for financially distressed businesses, and discussing proposed amendments to the *BIA* that are most relevant to business bankruptcies and proposals.[16] Part IV provides an overview of business insolvency in Canada, including a snapshot of insolvency by

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[12] Jocelyne Gosselin, Benoit Mario Papillon, *Empirical Analysis of the Effectiveness of the Reorganization Procedures Under the BIA and the CCAA*; 2005, http://strategis.ic.gc.ca/eic/site/bsf-osb.nsf/vwapj/Papillon-Gosselin-2005-ENG.pdf/$FILE/Papillon-Gosselin-2005-ENG.pdf.

[13] Jocelyne Gosselin, Benoit Mario Papillon and Sébastien Deschênes, *Summary of the Analysis of the Potential Effects of Commercial Insolvency Legislation on the Terms and Conditions of external financing for SMEs,* 2007, http://strategis.ic.gc.ca/eic/site/bsf-osb.nsf/vwapj/SummaryReport_EN.pdf/$FILE/SummaryReport_EN.pdf.

[14] The Canadian Insolvency Foundation is dedicated to research and education in insolvency law and practice.

[15] David Baird, "A Tribute to Lloyd W. Houlden", in J. Ziegel and D. Baird, eds., *Case Studies in Recent Canadian Insolvency Reorganizations, In Honour of the Honourable Lloyd W. Houlden,* (Toronto, Carswell, 1997) at xxviii.

[16] *An Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act,* Statutes of Canada, Chapter 36, Royal Assent, 14 December 2007, part proclaimed in force 7 July 2008; the remainder not yet proclaimed in force as of March 31, 2009 (Chapter 36).

major economic sector and region. Part V examines the primary causes of business insolvency, comparing electronic data, paper files and results of a trustee survey. Part VI provides a summary analysis of the sources of debts and type of assets that business debtors bring to insolvency proceedings, including examination of how debt and asset ratios may influence choice of proceeding and outcome. Part VII discusses the success and failure of business proposals, the underlying reasons, and recovery rates where data is available. Part VIII explores factors that may influence the type of proceeding, including use of receivership, voluntary versus involuntary filing, choice of the *BIA* proposal proceeding over the *CCAA*, debtor in possession financing for *BIA* proposals, and resources for small businesses. Part IX discusses research issues identified by trustees as important future projects. Finally, Part X offers some initial policy observations and conclusions.

II. SCOPE AND OBJECTIVES OF THE STUDY

The overall objective of the research project was to acquire a deeper understanding of the reasons for, and mechanisms to resolve, business insolvency. A working hypothesis of the study was that there are multiple causes of business failure, some of which are related to the experience and skills of the principals of the business and some of which are related to more general economic conditions that are beyond the control of individual directors and officers. A second working hypothesis was that the nature of debt may be changing, such that businesses are facing greater challenges than previously in their credit relationships. Another working hypothesis was that the reported rate of proposal failure may change once one excludes those proposals or notices of intention to make a proposal that are filed only to provide breathing space for the debtor business until it can be decided whether to restructure or liquidate.[17] A clearer understanding of the causes and solutions to business insolvency may assist in designing improvements to the insolvency system.

The study undertook an empirical and qualitative analysis of both business bankruptcies and proposals in 2005-2008. There were a number of research questions that the project sought to answer. What are the principal causes of business failure in Canada? Are there distinctions in the number of voluntary versus involuntary bankruptcies in terms of type of business, size and sector? Does the *BIA* create the appropriate incentives for timely filing of bankruptcy? What are the principal sources of debt of insolvent businesses? Does credit card debt pose a significant problem in commercial insolvency, as it has for consumer debtors? What factors drive the filing of a proposal as opposed to bankruptcy? The study also examined the pressure points in terms of failure of commercial proposals at various stages of the process. Given that there appears to be a relatively high failure rate for commercial proposals, what factors contribute to the success or failure of proposals, and what policy changes would increase the rate of successful completion of proposals? Is asset to debt ratio a predictor of which proposals will be successfully completed? Will current proposed amendments encourage more debtors to undertake proposals? A number of these research questions were examined by type of filing; and then a comparative analysis undertaken between the categories, with attention, where possible, to differences between sole proprietorships, partnerships, and incorporated businesses.

[17] Point of filing in this context is where the debtor files to provide a 30 day breathing period under the stay provisions, so that the debtor can determine what to do in the insolvency.

The study gathered information on as many of these questions as possible, and then analysed the data in order to better understand the benefits and challenges of the current system. Only some of these questions were possible to answer with the nature and type of data available. This information may better inform how the system supports or fails to support commercial workouts. While firm failure is an inevitable consequence of a market economy, there may be elements in the current system that encourage premature liquidation that could be remedied.

1. Research Methodology

There were four components to the research undertaken. First was to research comparable studies that have been undertaken, as well as searching for scholarly or industry reports or studies in other jurisdictions, in order to assist in framing the questions in this study. Such studies continue to be relatively rare, in part due to the fact that many jurisdictions do not yet collect detailed data on insolvency.

The study then utilized this information to design research fields for retrieval of electronic records, working with staff and economists at the OSB. The data was generated by region across Canada to be representative of the breakdown of businesses filing in various regions, in order to create an accurate representative sample. The study concentrated on business debtors that filed 2005 to 2008, examining 5,600 businesses, of which 5515 were electronic files and 85 were paper files. The OSB's e-filing system accepts summary administration files and Division II proposal files for individuals, joint estates, and debtors residing outside of Canada.[18] The e-filing system allows filing of ordinary administrations for individuals and corporations.[19] The system does not accept summary or ordinary administrations or Division II proposals for partnerships. The e-filing system will accept Division I proposals or Notices of Intention to make a proposal, including notices of intention for individuals and corporations, but not for partnerships or joint estates.[20]

The OSB defines business insolvency as "any commercial entity or organization other than an individual, or an individual who has incurred 50 percent or more of total liabilities as a result of operating a business".[21] Hence, the data available on business insolvency also include individual debtors that have sizeable consumer debt, but whose debts are 50% or more business related. Most of those individuals are sole proprietors.

The OSB data allowed for global analysis of the data for which there exist discrete electronic data fields, such as total assets and sources of debt. While the data set was relatively complete in respect of these fields, there were files in which fields

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[18] Plus, it accepts proposals and administrations for repeat debtors, and for administrations, for deceased debtors if a court order has been obtained; OSB, "E-Filing, A step-by-step approach", http://strategis.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br01972.html.

[19] Plus repeat debtors and debtors residing out of Canada; OSB, "E-Filing, A step-by-step approach", http://strategis.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br01970.html.

[20] It also accepts repeat debtors and debtors residing outside of Canada, but not administrations with a sealed document; OSB, "E-Filing, A step-by-step approach", http://strategis.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br01967.html.

[21] Office of the Superintendent of Bankruptcy (OSB), http://strategis.ic.gc.ca/epic/site/bsf-osb1.nsf/en/br02068e.html#tbl4.

had not been completed with information, although these files were a small minority of the total files examined.[22]

The study then analyzed the cases to determine the causes of business insolvency. One problem that currently exists with the electronic data is that there are not separately captured electronic fields for cause of insolvency. To date, most information is accessible only by manually pulling the data. Hence, the data on reasons for filing *BIA* proceedings had to be manually pulled from the files, assessed in terms of primary and secondary causes of insolvency and then entered into an Excel database. This extraction was a very labour intensive task, undertaken primarily by UBC law students. A methodology for analyzing the data was developed, coding variables within cases on a consistent basis so that comparisons could be generated across region and cohort. The first commercial proposals were filed electronically during the period of this research, a shift in data collection that will be increasingly helpful in the future, in terms of access to information.

The OSB's move to e-filing and the collection of data have been extremely important initiatives for both government policy makers and scholars, in that it offers the opportunity to examine empirically what is occurring in the field. However, the accuracy of that data is dependent on how fields such as causes are reported by debtors and their trustees. It may also be dependent on type of filer, in that at least some trustees report that corporate proposals often have more detailed disclosure of issues such as causes of insolvency than those filed by sole proprietors, which can be less particularized and not particularly informative. The study revealed that there can be gaps in reporting of information that is not purely financial, an area that could be improved in the future.

Part of the condition for access to OSB's the electronic data was that paper files be examined in several regions, in order to determine whether those files were consistent with information in the electronic files. Hence, the author and research assistants travelled to OSB offices in Toronto, Halifax, Calgary and Vancouver to examine representative paper files selected based on the regional breakdown of number and types of business insolvencies, on a random basis by OSB staff. The staff at the OSB offices in Halifax, Toronto, Calgary and Vancouver, as well as the federal office in Ottawa, were most helpful in arranging for us to attend at the offices and examine the files. 85 files were examined, roughly in proportion to the number of business insolvency filings for the particular regional office. The data from the 85 files are reported separately, for comparative purposes with the electronic data. The data from the study undertaken by Professors Gosselin and Papillion of files in Montréal and Québec City is also referred to where appropriate.[23]

The information generated by study of the OSB data was supplemented by information gathered from a group of trustees in the insolvency professional community, who work on a daily basis with insolvent businesses. The study undertook a survey of 50 trustees across Canada, by telephone, e-mail correspondence and in-person interviews, in order to draw from their experiences with commercial insolvencies under the *BIA*. The first set of these interviews was conducted in August 2008, drawing 32 responses. In order to have better regional representation and more representation from the national accounting firms, a further initiative was undertaken in September and October 2008 to bring the

[22] Given that some data collection is relatively recent by the OSB, the completeness of the data is likely to be enhanced in the future.
[23] Josselin and Papillion, *supra*, note 12.

sample up to 50 trustees.[24] Follow-up interviews were conducted with 20 of the trustees in respect of changing economic conditions, solely to examine whether, in their view, the primary causes of insolvency were shifting toward the end of 2008 and early 2009. The first-hand experience of these professionals generated some meaningful observations, particularly in respect of small businesses. This qualitative information is discussed throughout the report as a supplement to the empirical data. It provides insights into the nature and causes of business insolvencies, and problems associated with the current framework.

2. Limitations to the Data

There are two important caveats to interpreting the data. The first is that while ostensibly debtors fill out the reasons for filing, they do so with the assistance of the proposal trustee, administrator, trustee in bankruptcy, or in some cases, debtor's lawyers, particularly where there is a corporate proposal. While many insolvency professionals encourage accurate reporting, there were cases where the trustee used particular brief catch-all phrases, such as "failed business", which give little indication of the underlying causes of insolvency or how the route chosen, bankruptcy or proposal, addresses those causes. This failure to be specific creates difficulty for creditors, registrars and judges in trying to discern the real causes of the financial distress and in turn, to determine whether the insolvency option selected best addresses that distress. It merits note that corporate proposals were more detailed as to their causes in a number of files, compared with those of sole proprietors, which in a number of instances were more generalized. The lack of data makes it difficult for the registrar or the court to approve proposals that directly address the causes of the insolvency.

Second, given that the data were in a free form field, in some cases giving extensive detail as to underlying causes of insolvency, we were required to make some arbitrary choices as to how to collate the data, using protocols to ensure consistency in how data were analysed across different responses.

One limitation to analyzing the data filed with the OSB was that there were numerous instances in which insolvent debtors listed more than one cause of insolvency, for example, mismanagement combined with over-extension of credit. For purposes of examining the files, we took the declared primary and secondary causes, but it is important to note that there are frequently synergistic contributions to financial distress that are not captured when reporting global statistics.

There are also several issues in respect of the OSB's collection of data that merit note. The information is not as transparent as it could be in terms of how it is collated and reported. For example, both "business insolvency" and "commercial insolvency" are reported. In the OSB's *Annual Statistical 2007 Report,* insolvency is reported by administrative type. Commercial proposals include those proposals under Division I plus all notices of intention to make a proposal, regardless of debt type. Consumer Proposals are those under Division II. In another report for the same period, *Insolvency in Canada in 2007,* OSB reports business insolvency by type of debt, business proposals are those with 50% or more business debt, including Division I corporate files, Division I sole proprietorships, and Division II

[24] It is important to note that the list of acknowledgments at the front is a list only of those that wished to be publicly thanked. There were a number of trustees in large national firms that participated, but did not wish to be publicly acknowledged.

sole proprietorships.[25] These definitions generate quite different numbers and are not readily apparent in some of the publications, a matter that could be easily remedied.

The age of businesses is not collected by the OSB, so there are no data on the number of established businesses that are failing, as compared with start-up businesses. The data is also not available broken down by size within each sector, which could offer rich insights into business financial distress. Nor are the number of employees affected collected, although some of that data may be generated in the future by the Wage Earner Protection Program. Recoveries under business proposals are not collected and reported in easily accessible fashion, although the OSB was able to generate some data, as discussed in this study.

One very important limitation to this study was that it did not seek the direct input of business debtors through survey or other means. As discovered in a previous empirical study of elderly consumer debtors, it is difficult to directly canvass individual debtors, given their vulnerability, fear of public exposure and current university ethics standards for contact with study populations.[26] It is also extremely expensive to undertake such research, but the data generated would be a valuable analytical tool in future policy development.

Some important fields of data, such as numbers of employees of insolvent businesses, are not collected at all. Nor does the OSB track outcomes after proposals are concluded, making it impossible to assess medium to long term effectiveness of the *BIA* provisions. The OSB should consider undertaking a public consultation and then revision of its forms, in order to ensure enhanced data collection in the future.

Finally, one objective of the study was to unearth more information regarding differences between publicly traded and privately held corporations, in terms of type of debt, causes of financial distress and outcome. However, the data sets did not give company names and thus research had to be conducted in reverse order, with media searches for publicly traded companies in financial distress, research of publicly available information on SEDAR for locating type of filing and outcome where possible, and then matching to OSB data. One problem with SEDAR data is that once a company is no longer listed, it no longer files information on SEDAR, often at the point of further financial distress. As discussed below, this task was undertaken for ten sample files; however, it does not provide a sufficient sample size to allow for reliable conclusions. It remains a future research project that could offer new insights.

The next part briefly canvasses the legislative framework, for those readers unfamiliar with options for insolvent businesses under the *BIA*. It sets the backdrop for the analysis of data that follows.

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[25] Correspondence with Stephanie Cavanagh, OSB, 18 December 2008, clarifying the different reported global statistics for 2007. Sole proprietorships breakdown is a third way to break down the business files, with bankruptcies and proposals are added together.

[26] J. Sarra, "Growing Old Gracefully, An Empirical Investigation into the Growing Number of Bankrupt Canadians over Age 55", *2006 Annual Review of Insolvency Law* (Toronto: Carswell, 2007).

III. THE LEGISLATIVE FRAMEWORK

It is helpful to briefly provide an overview the types of proceedings available to business debtors under the *BIA* when they are insolvent; specifically, bankruptcy, Division I and Division II proposals.[27] As of March 31, 2009, there continue to be recent amendments to the *BIA* that have been enacted but are not yet proclaimed in force.[28] Some of these amendments relate directly to business insolvency and are noted in the discussion, where appropriate.

There are a number of possible outcomes to business financial distress, including a private workout with creditors where there is not any formal proceeding, a new equity injection, the appointment of a receiver, formal restructuring proceedings, or bankruptcy and liquidation.[29] In bankruptcy, the assets of a company vest with a trustee in bankruptcy, which sells the business as a going concern or liquidates the assets and distributes the proceeds among creditors according to the priority of their claims as set out in the *BIA.* Outside of bankruptcy, however, there are a number of mechanisms that facilitate the business debtor carrying on as a going concern, such as arrangements pursuant to the corporations law under which the company is incorporated. Under insolvency legislation, there can also be an arrangement under both the highly codified *BIA* and the more skeletal *CCCA*.[30]

The *BIA* provides a mechanism for a party making an application for a bankruptcy order in respect of insolvent debtors and liquidating their assets, as well as providing a series of interim mechanisms such as appointment of receivers to take conservatory and other measures for the protection of assets that creditors can lay claim to because of the firm's financial distress.

In addition to its debt collection mechanism, the *BIA* also provides a scheme for commercial proposals, in order to allow an insolvent business an opportunity to restructure its affairs to become financially viable. Proposal is defined in the *BIA* as including a "proposal for a composition", where creditors agree to accept less than full repayment or agree to an extension of time; and/or a scheme of arrangement in terms of alteration of debt and equity structure.[31] The premise is that by reducing the amount of debt, renegotiating payment terms, or terminating costly contracts, the business debtor can turn around its financial affairs and become viable again.

On filing either a proposal or a notice of intention to make a proposal, there is an initial automatic stay on creditors moving to enforce any of their claims for a thirty day period, which gives the insolvent debtor a chance to negotiate with creditors for a possible proposal and going-forward business plan. Corporate officers retain control of the corporation's assets and operations during the proposal process, and the trustee that assists with development of the proposal acts in a monitoring and advisory capacity, as opposed to taking over control of the company. The *BIA* proposal proceedings are used for individuals and for all sizes of business, from sole proprietorships, to partnerships, to corporations of various sizes.

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[27] There are alternatives to proceedings under the *BIA*; however, such options are beyond the scope of this paper.

[28] Statutes of Canada, Chapter 36, *supra*, note 16.

[29] R. Yalden, J. Sarra *et al,* Corporations, Policies, Principles and practice (Toronto, Emond Montgomery Publications, 2007) at chapter 14.

[30] A discussion of the *CCAA* is beyond the scope of this paper. For a discussion, see Janis P. Sarra, *Rescue! The Companies' Creditors Arrangement Act* (Toronto: Carswell, 2007).

[31] *BIA*, s. 2(1).

1. Bankruptcy

Turning first to bankruptcy, an insolvent person can make an assignment in bankruptcy or creditors can file an application for a bankruptcy order in respect of the person.[32] "Person" is defined in the *BIA* as:

> "person" includes a partnership, an unincorporated association, a corporation, a cooperative society or an organization, the successors of a partnership, association, corporation, society or organization, and the heirs, executors, liquidators of the succession, administrators or other legal representative of a person, according to the law of that part of Canada to which the context extends.[33]

Corporation is defined under the *BIA* as:

> "corporation" includes any company or legal person incorporated by or under an Act of Parliament or of any province, and any incorporated company, wherever incorporated, that is authorized to carry on business in Canada or that has an office or property in Canada, but does not include banks, authorized foreign banks within the meaning of section 2 of the *Bank Act,* insurance companies, trust companies, loan companies or railway companies;[34]

Proposed amendment to the definition of corporation will bring income trusts into the definition.[35]

A business debtor can make an application for assignment into bankruptcy, called a voluntary filing. Creditors can also apply for a bankruptcy order against a debtor, called involuntary filing. Pursuant to section 43(1) of the *BIA*, a creditor may file an application for a bankruptcy order against a debtor, defined as an insolvent person, who, at the time an act of bankruptcy was committed by him or her, resided or carried on business in Canada.

The *BIA* defines insolvent person in section 2 for purposes of access to the statute:

> 2 … "insolvent person" means a person who is not bankrupt and who resides, carries on business or has property in Canada, whose liabilities to creditors provable as claims under this Act amount to one thousand dollars, and

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[32] For an explanation of the provisions, see L. Houlden, G. Morawetz and J. Sarra, *The 2008 Annotated Bankruptcy and Insolvency Act* (Toronto: Carswell, 2007), Part II, Bankruptcy Orders and Assignments, at 130-201.

[33] *BIA,* s. 2. Chapter 36 changes the definition to: " 'person' includes a partnership, an unincorporated association, a corporation, a cooperative society or a cooperative organization, the successors of a partnership, of an association, of a corporation, of a society or of an organization and the heirs, executors, liquidators of the succession, administrators or other legal representatives of a person;" Chapter 36, *supra*, note 16.

[34] *BIA,* s. 2. The definition will be amended by Chapter 36 to specify: " 'corporation' means a company or legal person that is incorporated by or under an Act of Parliament or of the legislature of a province, an incorporated company, wherever incorporated, that is authorized to carry on business in Canada or has an office or property in Canada or an income trust, but does not include banks, authorized foreign banks within the meaning of section 2 of the *Bank Act*, insurance companies, trust companies, loan companies or railway companies;"

[35] Statutes of Canada, Chapter 36, *supra*, note 16.

> (a) who is for any reason unable to meet his [her, or its] obligations as they generally become due,
> (b) who has ceased paying his [her, or its] current obligations in the ordinary course of business as they generally become due, or
> (c) the aggregate of whose property is not, at a fair valuation, sufficient, or, if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable payment of all his obligations, due and accruing due.

The *BIA* sets out ten acts of bankruptcy, the most commonly relied on act being that the insolvent person has ceased to meet liabilities as they generally become due.[36] Other acts of bankruptcy include: if the debtor makes an assignment of his or her property to a trustee for the benefit of creditors generally; if the debtor makes a fraudulent gift, delivery or transfer of the debtor's property or of any part of it; if the debtor makes a fraudulent preference; if the debtor departs out of Canada with intent to defeat or delay creditors, or remains out of Canada, or otherwise absents himself or herself; if the debtor permits any execution or other process issued against the debtor under which any of the debtor's property is seized, levied on or taken in execution, subject to specified conditions; if the debtor exhibits to any meeting of his or her creditors any financial statement that shows that he or she is insolvent, or presents a written admission of inability to pay his or her debts; if the debtor attempts to or does assign, remove, secrete or dispose of property with intent to defraud, defeat or delay creditors; if the debtor gives notice to any creditors that he or she has suspended or is about to suspend payment of debts; and if the debtor defaults in any proposal made under the *Act*. The act of bankruptcy must have occurred within six months preceding the filing of the application for a bankruptcy order.

When a debtor is insolvent and seeking access to the *BIA*, a trustee in bankruptcy reviews the debtor's financial situation, explains the various options available, and in the case of insolvent individuals, including those operating businesses, determines whether any surplus income payments are required. At the first meeting of creditors, inspectors are generally appointed, who stand in a fiduciary relation to the general body of creditors, and who perform specified duties under the *Act* in the interests of creditors, including periodic verification of the trustee's accounts, and approval of the trustee's final statement of receipts, disbursements, dividend sheet and disposition of unrealized property.[37] Inspectors generally advise the trustee during the course of the proceeding.

All insolvent individuals are required to take counselling on money management, warning signs of financial difficulties, and obtaining and using credit, as well as counselling advice on creating a financial plan of action.

For individuals, including business sole proprietors, automatic discharge is available for first-time bankrupts nine months after they make an assignment or are ordered into bankruptcy, unless the trustee recommends a discharge with conditions or it is opposed by a creditor, the trustee, or the Superintendent of Bankruptcy. The *BIA* sets out fifteen facts for which discharge may be refused, suspended or granted conditionally, including that the assets of the bankrupt are not of a value equal to fifty cents on the dollar on the amount of the bankrupt's unsecured liabilities, unless the bankrupt can satisfy the court that this situation has arisen from circumstances for which the bankrupt cannot justly be held responsible; the bankrupt has continued to trade after becoming aware of being insolvent; the

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[36] *BIA*, s. 42(1).
[37] *BIA*, s. 116-120, *Re Bryant Island & Co.* (1923), 4 C.B.R. 41 (Ont. S.C.) at 48.

bankrupt has failed to account satisfactorily for any loss of assets; and the bankrupt has contributed to the bankruptcy by rash and hazardous speculations, by unjustifiable extravagance in living, by gambling or by culpable neglect of the bankrupt's business affairs.[38] A conditional discharge may also be imposed where the bankrupt did not pay the agreed amount of surplus income, or the bankrupt filed for bankruptcy instead of proposing a viable proposal.

For second time bankrupts or those who do not qualify for an automatic discharge, the trustee is required within one year from the beginning of the bankruptcy to apply to the court for a hearing of the application for a discharge.[39] The court can order an absolute discharge for a first time bankrupt;[40] or a conditional or suspended discharge for any bankrupt, the latter requiring particular conditions be satisfied before the discharge is final.[41]

The effect of bankruptcy for individuals involved in business or for consumer debtors is a "fresh start" financially. The bankrupt is released of most debts; however, specified debts are not released, for example, an award for damages in respect of an assault, spousal or child support, a debt arising out of fraud, any court fine, and debts for student loans when the bankruptcy occurs while the debtor is still a student or within seven years after the bankrupt has ceased to be a student.[42] The fresh start framework of bankruptcy under the *BIA* allows the bankrupt to begin to rebuild his or her credit rating and affords the bankrupt relief from the crushing burden of debt.

For incorporated businesses, bankruptcy frequently entails winding-up the company and liquidation of all the assets, in order to pay out creditors based on the hierarchy of claims set out in the statute. In this respect, bankruptcy is an effective means of pulling value of the assets, such as accounts receivable, into the bankruptcy estate and ensuring an expeditious and fair distribution of the proceeds from the estate. Sometimes the corporate shell is preserved, if there is value to its continuation. Sometimes the bankruptcy involves a going concern sale of all or part of the business, aimed at preserving value of the business and customer goodwill. Most often, however, the incorporated business ends and individuals that are principals of the entity are free to move their employment activities elsewhere, offering a different kind of fresh start.

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[38] *BIA*, s. 173(1).

[39] When the recent amendments to the *BIA* come into force, there will be the availability of automatic discharge for second time bankrupts.

[40] *BIA*, s. 172(2).

[41] *BIA,* s. 172(2). Section 172(1) to (3) specify: 172. (1) On the hearing of an application of a bankrupt for a discharge, the court may either grant or refuse an absolute order of discharge or suspend the operation of the order for a specified time, or grant an order of discharge subject to any terms or conditions with respect to any earnings or income that may afterwards become due to the bankrupt or with respect to his after-acquired property. (2) The court shall on proof of any of the facts mentioned in section 173 (*a*) refuse the discharge of a bankrupt; (*b*) suspend the discharge for such period as the court thinks proper; or (*c*) require the bankrupt, as a condition of his discharge, to perform such acts, pay such moneys, consent to such judgments or comply with such other terms as the court may direct. (3) Where at any time after the expiration of one year after the date of any order made under this section the bankrupt satisfies the court that there is no reasonable probability of his being in a position to comply with the terms of the order, the court may modify the terms of the order or of any substituted order, in such manner and on such conditions as it may think fit.

[42] *BIA*, s. 178(1), as amended by S.C. Chapter 36, effective July 7, 2008. A student can apply for relief for financial hardship provisions after five years, s. 178(1.1).

i. Proposed Bankruptcy Reforms

Amendments to the *BIA*, some of which were proclaimed in force in July 2008 and others that are expected to come into force in 2009, address a number of problems previously identified in the *BIA*. In terms of the changes most relevant to business bankruptcy, this part offers a very brief summary of changes that are aimed at streamlining business bankruptcy and enhancing creditor rights. Overall, the amendments are aimed at encouraging more proposals as an alternative to bankruptcy and liquidation; streamlining both the bankruptcy and proposal process; reducing the need for costly proceedings; enhancing protection to employees of insolvent businesses; and offering greater liability protection for trustees and other insolvency professionals where they act in good faith and are duly diligent.

Sections 30(1) and 30(2) of the *BIA* set out the powers that may be exercised by the trustee with the permission of the inspectors. Inspectors assist in the administration of the business bankruptcy. However, when an estate is small and creditors do not believe that recovery is likely, they may not expend the resources to have inspectors appointed. The amendments will provide that in the absence of inspectors, the trustee can act unilaterally so that an estate is not left in limbo when inspectors are not appointed, assisting in the bankruptcy of small businesses.

A trustee will be required to obtain court approval before selling or disposing of the bankrupt's property to a person who is related to the bankrupt.[43] This new provision is aimed at preventing possible abuse involving the sale of assets to related parties through the bankruptcy process; and the amendments set out the factors the court must consider before granting an order to sell the property to a person related to the bankrupt.[44] It will allow related persons to buy the property, facilitating bankruptcy proceedings for businesses with few assets, as often such persons are the only parties willing to buy the business. However, the provisions also set safeguards to prevent abuse. Receivers, under the new provisions, will also be able to seek approval of the court for a similar sale of assets.[45]

Currently, the provision to protect unpaid suppliers creates a 30-day period from delivery to repossession of goods, allowing suppliers to repossess goods recently supplied to the debtor if they meet specified criteria. The 30-day period causes some difficulty because the unpaid supplier often does not have sufficient time to act. The amendments will extend the window from 30 days to 45 days; an unpaid supplier may repossess goods delivered any time in the 30 days prior to a bankruptcy and has a period of 15 days after such filing to do so. The 15-day period is aimed at providing suppliers with a sufficient period to act to defend their interests.[46] There may be some question as to whether the amendments will accomplish there intended goal with notices only required to be sent out within five business days of the trustee's appointment.[47]

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[43] Proposed section 30(4).
[44] Proposed section 30(6).
[45] Proposed section 243(1)(c).
[46] Section 81.1(1) will provide for the situation where the debtor places the goods with an agent, for example, a warehouse. Previously, some courts had found that in such a situation, the supplier had no recourse to repossess the goods. Second, the reform provides a supplier with the right to request repossession of goods within a set period of 15 days after the debtor becomes bankrupt or a receiver is appointed in respect of property of the debtor of terms used in the section.
[47] *BIA,* s. 102.

In terms of employee compensation claims, effective July 7, 2008, the *BIA* created a limited super-priority in a bankruptcy or a receivership in favour of employees for unpaid wage claims over current assets up to a maximum of 2,000 CAD in respect of wages and 1,000 CAD in respect of disbursements owing to travelling salespeople, for the six month period prior to proceedings. The reforms also create a super-priority for claims related to unremitted pension contributions outstanding when an employer becomes bankrupt. The changes will offer greater protection to employees at the point of business insolvency. They complement the new Wage Earner Protection Program, which provides for the payment of outstanding wages, capped at 3,000 CAD, to individuals whose employment is terminated as a result of a bankruptcy or receivership.[48]

Proposed sections 95, 96 and 96.1, when proclaimed in force, will create a complete framework for challenging transactions that may diminish the value of the insolvent business debtor's estate, reducing the amount of money available for distribution to the creditors. These types of transactions are called preferences and transfers at undervalue.[49] A preference occurs when an insolvent debtor pays one or more creditors at the expense of other creditors. A transfer at undervalue is disposition of property or provision of services for which no consideration is received by the debtor or for which the consideration received is conspicuously less than the fair market value of the consideration given by the debtor. There are different periods under which transfers will be examined depending on whether the counterparty was an arm's length party or not.

A number of amendments are aimed at personal insolvency. However, where a business is comprised of a sole proprietor of an unincorporated business, the debtor files an as individual. Proposed section 68(3) requires the trustee to determine whether the bankrupt has surplus income, and the trustee must assess the issue of surplus income again whenever the trustee becomes aware of a material change in the bankrupt's circumstances. If the trustee determines that the bankrupt has surplus income, the trustee is to fix the amount payable to the bankrupt's estate, inform the official receiver and creditors, and take reasonable measures to ensure that the bankrupt complies with the requirement to pay.[50] The court may amend an order to take into account material changes in the bankrupt's financial situation.[51] These changes allow the surplus income payments to reflect the ability of the business debtor to make payments.

Section 104(1) of the *BIA* will be amended to encourage more creditors to participate in the process by providing them with information they need to make informed decisions, including an agenda outlining the items for discussion at creditors' meetings with a reasonable explanation of what is expected to be discussed. Here again, the amendment is aimed at individual bankruptcy, but may

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[48] The *Wage Earner Protection Program Act* came into force effective July 7, 2008. The term "wages" is defined to include salary and vacation pay, but does not include severance or termination pay.

[49] The current provisions deal with settlements, reviewable transactions and preferences, which will be replaced by the new provisions.

[50] However, if the trustee determines that the bankrupt has no surplus income, the trustee still must provide this information to the official receiver and every creditor who has requested it. Section 68(5) will provide that if the official receiver determines the bankrupt is able to pay a different amount than that fixed by the trustee, the official receiver may recommend this new amount to the trustee. At this point, the trustee may fix another amount and inform the official receiver and every creditor and take reasonable measures to ensure that the bankrupt complies with the requirement to pay, Chapter 36, *supra*, note 16.

[51] Proposed section 68(12).

include sole proprietors. The amendments will increase the opportunity for creditor participation by providing that a request for a first meeting of creditors does not have to be made within the 30 days after the date of bankruptcy. Currently, the statute requires that a creditor or the official receiver request a meeting within 30 days of the date of bankruptcy. By removing this limitation, creditors may be encouraged to participate in summary administration bankruptcies.

If a first-time bankrupt has been required to make payments under s. 68, the bankrupt will be eligible for an automatic discharge 21 months after the date of bankruptcy unless an opposition has been filed before the automatic discharge takes effect. Eligibility for an automatic discharge will be available to second-time bankrupts under certain circumstances. Second-time bankrupts with surplus income will have to make payments for a longer time period, and will be eligible for automatic discharge 36 months after the date of bankruptcy.[52] Increasing the circumstances in which individuals are eligible for an automatic discharge streamlines the bankruptcy process by eliminating the necessity of a court appearance in certain cases.

Proposed section 172.1 will introduce a new procedure for discharging bankrupts with high personal income tax debt, including sole proprietors of non-incorporated businesses. It is aimed at those individuals who have an outstanding federal or provincial personal income tax debt in excess of 200,000 CAD, including principal, interest and penalties, where the amount owing represents 75% or more of the bankrupt's total unsecured proven claims. The proposed section is aimed at ensuring that bankrupts with significant personal income tax debt do not take advantage of the insolvency system by paying their other creditors to the exclusion of the government. These bankrupts will not be eligible for an automatic discharge and an application for discharge will be required. For bankrupts with high income tax debts, a hearing on an application for discharge for a bankrupt who has never been bankrupt before may not be held before the expiry of nine months after the date of bankruptcy if the bankrupt has not been required to make payments under section 68 to the estate or 21 months after the date of bankruptcy in any other case.[53]

For bankrupts with high income tax debt who have been bankrupt once before, a hearing on an application for discharge may not be held before the expiry of 24 months after the date of bankruptcy if the bankrupt has not been required to make payments under section 68 to the estate or 36 months after the date of bankruptcy in any other case.[54] A hearing of an application for a discharge for a bankrupt who has been bankrupt two or more times before may not be held before the expiry of 36 months after the date of bankruptcy.[55]

Proposed section 172.1(3) specifies the types of orders that the court may make on the hearing of a bankrupt's application for discharge: refuse the discharge; suspend the discharge; or require the bankrupt to perform any acts, pay any money, consent to any judgement, or comply with any other terms that the court

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[52] A second-time bankrupt will be eligible for an automatic discharge 24 months after the date of bankruptcy unless an opposition to the discharge has been filed or the bankrupt has been required to make payments under s. 68. If the bankrupt has been required to make payments under s. 68, a second-time bankrupt is eligible for an automatic discharge 36 months after the date of bankruptcy unless an opposition has been filed before the automatic discharge takes effect.

[53] Proposed section 172.1(1)(a), 2007, c. 36, not yet proclaimed in force as of February 28, 2009.

[54] Proposed section 172.1(1)(b), 2007, *ibid.*

[55] Proposed section 172.1(1)(c), 2007, *ibid.*

may direct.[56] There are factors that the court must take into account when making a decision with respect to the bankrupt's discharge, including the bankrupt's circumstances at the time the personal income tax debt was incurred; the efforts made by the bankrupt to pay the personal income tax; whether the bankrupt paid other debts while failing to make reasonable efforts to pay the personal income tax debt; and the bankrupt's financial prospects for the future.[57] Income tax obligations related to acting as a director of a corporation are not to be included.[58]

Proposed section 243 grants authority to the court to appoint a receiver with the power to act nationally, thereby eliminating the need to apply to the courts in multiple jurisdictions for the appointment of a receiver, and in turn facilitating business insolvency proceedings. The provisions for interim receiver will be tightened up in terms of the length of time of the appointment.[59] The interim receiver, under the direction of the court, may take conservatory measures and summarily dispose of property that is perishable or likely to depreciate rapidly in value, and exercise such control over the business of the debtor as the court deems advisable.

Part XIII of the *BIA* will be also amended to largely adopt the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvencies, in order to facilitate cross-border business insolvency proceedings.

2. Proposals

Proposals have become a significant alternative to bankruptcy for both consumer and business debtors. There were 17,992 proposal estates closed in 2008, including both consumer and business proposals, with assets valued at 1,645,347,669 CAD and liabilities of 3,003,984,348 CAD. Of those estates, the trustees realized 360,239,869 CAD and dividends that were paid to creditors totalled 201,948,809.[60] In 2007, under *BIA* proposals, creditors realized 21.7% of the claims outstanding against the debtor.[61] This amount is considerably higher than what creditors, particularly unsecured creditors, can expect to receive in bankruptcy.

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[56] *Ibid.* Proposed section 172.1(2) specifies that the trustee must give five days notice to the bankrupt before applying to the court for an appointment for the hearing of the bankrupt's application for discharge.

[57] Proposed section 172.1(4), *ibid.* Proposed section 172.1(5) specifies that if the court suspends the discharge, the court shall order the bankrupt to provide the trustee with monthly income and expense statements and to file all income tax returns required by law during the period the discharge is suspended. Proposed section 172.1(6) enables the court to modify the order, at least one year after the date of the order, if the bankrupt satisfies the court that there is no reasonable probability that he or she will be in a position to comply with the terms of the order. Proposed section 172.1(7) grants the court authority to suspend and attach conditions to a bankrupt's discharge concurrently. Section 172.1(8) will define "personal income tax debt" for the purpose of the section (2007, c. 36, not yet proclaimed in force as of February 28, 2009).

[58] Proposed section 172.1(8), *ibid.* In those cases, the director may be found liable for debts of the corporation by virtue of his or her position. The intention of the reform was to address strategic bankrupts who failed to pay income tax, not to capture those who are deemed to be responsible for taxes owed by a third party.

[59] Proposed section 47(1).

[60] Administration costs for proposals totalled 224,728,745 CAD in 2006.

[61] OSB, Stephanie Cavanaugh, 2008. The figures are not yet available for 2008.

For insolvent businesses, there are two kinds of proposal provisions that the debtor may have access to under the *BIA,* Division I, and in specified circumstances, Division II.

i. Division I Proposals

Division I proposals are available for individuals and businesses, and frequently used where the debts are more than 75,000 CAD and thus Division II is not available.[62] This study examined only business proposals under Division I, either incorporated entities, partnerships, or individuals whose debts are comprised of 50% or more of business debts, collectively referred to as "debtors" here.

Under Division I, debtors can make a proposal to creditors or file a notice of intention to file a proposal.[63] Often the debtor needs time to prepare a proposal and so the legislation allows it to file a "notice of intention to make a proposal", allowing the debtor time to devise a viable going forward business strategy. A proposal trustee assesses the debtor's ability to make a proposal, monitors the process, and assists the debtor with mandatory filing requirements. The Division I proposal provisions are highly codified, creating some certainty and predictability for both debtors and creditors.

Filing a notice of intention to make a proposal creates an automatic stay for 30 days, and the court has the authority to extend the stay for periods up to 45 days to a maximum of six months. The stay affords the debtor breathing space to devise a proposal that will be acceptable to creditors.[64] The debtor must file a projected cash flow statement with a trustee and the trustee must report on the reasonableness of the statement.[65] When the debtor has a proposal to present to creditors, a meeting is called, which allows creditors to vote on the proposed plan.[66] The statute requires that a majority of creditors in number and two-thirds in value of the claims of each class of creditor vote in favour of the proposal.[67] If the debtor garners the requisite support, the proposal is brought to the court for approval.[68]

The *BIA* sets out specific requirements of the proposal, in terms of the priority of claims that must be observed in a proposal, the fees and expenses of the trustee, specified Crown claims, and specified amounts owing to employees where the debtor is a business.[69] The court has the authority to annul a proposal if there is a default in the performance of any provision of the proposal, where the court's approval was obtained by fraud, or where it appears that the debtor cannot continue the proposal without injustice or undue delay.[70]

While Division I proposals were originally aimed particularly at small and medium size businesses, in terms of giving them an accessible and cost effective mechanism to devise an arrangement with creditors to avoid bankruptcy and

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[62] Note that the threshold amount for access to Division II will change to 250,000 CAD when Chapter 36 is proclaimed in force.
[63] *BIA*, s. 50(1) and s. 50.4.
[64] *BIA*, s. 50.4.
[65] *BIA*, s. 50.4(2).
[66] *BIA*, ss. 51, 54.
[67] *BIA*, ss. 54, 62.
[68] *BIA*, ss. 58, 59.
[69] *BIA*, s. 60.
[70] *BIA*, s. 63.

liquidation, they have been used increasingly by individuals whose debts exceed the cap allowable under the Division II consumer proposal provisions. This use is likely to shift somewhat when the amendments to the *BIA* are proclaimed in force, in that the cap under Division II will be increased to debts of 250,000 CAD.[71]

ii. Division II Proposals

Division II proposals are available to insolvent individuals whose debts are less than 75,000 CAD, excluding a mortgage on the individual's principal residence.[72] The provisions were enacted as a mechanism to deal with smaller estates on a more cost-effective and expedited basis. The number of Division II proposals has been growing since their statutory introduction in 1993.[73] In 2006, more than 19,200 Division II proposals were filed, as opposed to 2,200 in 1993. Hence, 19.5% of insolvency files were proposal proceedings in 2006, compared with only 3.8% in 1993.[74] A Division II proposal must be made to creditors generally, but is not binding on secured creditors that have not filed a proof of claim.[75]

Division II proposals are consumer proposals. "Consumer debtor" is defined in the *BIA* as "a natural person who is bankrupt or insolvent and whose aggregate debts, excluding any debts secured by the person's principal residence, do not exceed seventy-five thousand dollars".[76] However, Division II proposals are available to sole proprietors that fall within the criteria in terms of amount of debt, and are defined by the OSB for data collection purposes as individual debtors for whom 50% or more of debts are business related. The data used in this study are only those individuals whose business debt was greater than 50% of their debts.

Division II proposal proceedings are commenced by the debtor obtaining the assistance of an administrator in preparing the proposal; and providing the administrator with the prescribed information on the debtor's current financial situation.[77] The duties of the administrator, a trustee or another insolvency professional, are set out in the statute.[78]

A person already bankrupt can also make a proposal, but it must be approved by the inspectors of the bankruptcy estate and the bankrupt must have obtained the assistance of a trustee who will be the administrator of the proposal.

The administrator investigates the debtor's property and financial affairs in order to assess with reasonable accuracy the debtor's financial situation and the cause of insolvency. The administrator provides counselling in accordance with directives issued by the OSB; prepares a proposal; and files a copy of the proposal, signed by the debtor, with the official receiver.[79] Within ten days following, the

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[71] Statutes of Canada, Chapter 36, *supra*, note 16.

[72] It is possible to make a joint consumer proposal to debtors who do not have total debts exceeding 75,000 CAD. Two or more consumer proposals may be joined where they could reasonably be dealt with together because of the financial relationship of the consumer debtors involved. *BIA*, s. 66.12(1.1).

[73] OSB, at 37.

[74] *Ibid.* More recent data were not yet available.

[75] *BIA*, s. 66.28.

[76] *BIA*, s. 66.11. That cap will increase to $250,000 when the new amendments are proclaimed in force.

[77] *BIA,* s. 66.13 (1).

[78] *BIA*, s. 66.13.

[79] *BIA.,* s. 66.13 (2).

administrator prepares and files with the official receiver a report on the results of the investigation; the administrator's opinion as to whether the proposal is reasonable and fair to the debtor and his or her creditors; whether the debtor will be able to perform the proposal; a condensed statement of the debtor's assets, liabilities, income and expenses; and a list of the creditors whose claims exceed two hundred and fifty dollars.[80]

A Division II proposal must provide for the payment of preferred claims; for the payment of all prescribed fees and expenses of the administrator related to the proposal proceedings and of any person providing counselling.[81] The proposal must also set out the manner of distributing dividends. A proposal typically takes three to five years to complete the payment schedule.

The administrator sends a copy of the proposal and the report to creditors, along with a claims form and a statement explaining that a meeting of creditors will be called only if the official receiver directs the administrator to call a meeting of creditors within 45 days, or if creditors having an aggregate of at least 25% in value of the proven claims request a meeting.[82] In most cases, no meeting of creditors to vote on the proposal is necessary.

Creditors have up to 45 days to consider whether to accept or reject the proposal. If creditors do not respond, they are considered to have accepted the proposal. If a sufficient number of creditors accept the proposal, it is binding on the debtor and creditors. Where, at the expiration of the 45 day period, no obligation has arisen to call a meeting of creditors, the proposal is deemed accepted by the creditors.[83] No court hearing is required, unless the administrator receives a request from the official receiver or any other interested party within 15 days of the acceptance or deemed acceptance of the proposal; and failing such request, the proposal is deemed approved by the court.[84] Hence, the proceeding is highly streamlined and cost effective, saving time and resources in terms of creditors' meetings and court appearances where creditors and the official receiver do not object to the proposal. When the proposal is fully performed, the administrator submits a certificate of full performance to the debtor and the official receiver.

If the proposal is rejected by creditors, the stay under the *BIA* is no longer in effect and creditors can move to enforce their claims. If a proposal is accepted and the debtor later fails to comply with the terms of the proposal, the court, on application, can annul the proposal. A Division II proposal is deemed annulled where payments under the proposal are to be made monthly or more frequently and the debtor is in default to the extent of three months payments; or where payments under a proposal are to be made less frequently than monthly and the debtor is in default for more than three months on any payment.[85] The exception to the deemed annulment is where the court has previously ordered otherwise or where an amendment to the proposal is filed before the deemed annulment.[86]

The court also will annul a proposal where it appears to the court that the debtor was not eligible to make a consumer proposal when the proposal was filed; where

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[80] *BIA.,* s. 66.14.
[81] *BIA,* s. 66.12(6).
[82] *BIA*, s. 66.15.
[83] *BIA*, s. 66.18.
[84] *BIA*, s. 66.22.
[85] *BIA*, s. 66.31.
[86] *BIA*, s. 66.31.

the proposal cannot continue without injustice or undue delay; or where the approval of the court was obtained by fraud.[87]

On annulment of a Division II proposal, if the debtor was insolvent prior to making the proposal, creditors have a claim against the debtor for the amount owed to them before the proposal, minus any amount the debtor paid them during the proposal. If the debtor was bankrupt when the proposal was made and the court subsequently annuls the proposal, the debtor is reinstated as a bankrupt on the date of the annulment.

The OSB reports that the success rate of Division II proposals is about 70%. For the remaining 30%, it is important to examine at what point the proposal fails, as discussed below in Part VII. By way of comparison, the failure rate under Chapter 13 of the U.S. *Bankruptcy Code* is more than double this rate.[88]

Professors Ziegel, Telfer and Duggan have suggested that there are two possible explanations for the growth in Division II proposals since the mid-1990s, the first being that in 1997, amendments to the *BIA* required individual bankrupts to make mandatory surplus income payments; and second, the fee structure in the bankruptcy rules was substantially altered in 1998 to give trustees a stronger incentive to recommend consumer proposals to debtors.[89]

iii. Reforms to Proposal Provisions

There are extensive proposed amendments to the proposal provisions of the *BIA*, aimed at enhancing the ability of business debtors to effectively restructure where they can devise a viable business plan. The provisions will be particularly helpful to SMEs as they codify rights and expectations in respect of restructuring.

Proposed changes to s. 50 of the *BIA* under Chapter 36 are aimed at increasing the use of proposals by establishing clear rules on proposals to better allow debtors to negotiate payment arrangements with creditors. The amendments will require the filing of a prescribed form, which will bring consistency to the process of filing a proposal.[90] The amended s. 50(6)(a) will require a cash-flow statement on at least a monthly basis, prepared by the person making the proposal and reviewed by the trustee for its reasonableness.[91] Both the proposal trustee and the person

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[87] *BIA*, s. 66.30.

[88] Jacob Ziegel, Anthony Duggan and Thomas Telfer, *Canadian Bankruptcy and Insolvency Law, Cases, Text and Materials* (Toronto: Emond Montgomery, 2003) at 614. They suggest that the higher U.S. rate is due to the fact that the ratio of Chapter 13 to Chapter 5 cases is about twice the ratio of consumer proposals to bankruptcies in Canada, and hence a number of debtors appear to be opting for proposals when perhaps they should be in liquidation, and second, that U.S. consumers have previously had stronger incentives to opt for Chapter 13, even where the prospects for successful plan completion are not good. The incentives include the fact that Chapter 13 has a substantially higher ceiling for the admissible amount of debt; it permits the debtor to modify the rights of holders of secured claims, other than a claim secured only by a security interest in the debtor's principal residence and provides for the waiving or curing of any default; the list of non-dischargeable debts is smaller in Chapter 13 than it is for Chapter 7 filings; and the courts can grant hardship relief, although this authority is rarely exercised, *ibid.* at 612-614.

[89] *Ibid.* at 613.

[90] Proposed amendment to s. 50(2), *BIA,* Statutes of Canada, Chapter 36, *supra*, note 15.

[91] A new s. 50(2.1) will be enacted to ensure that the official receiver receives the documents in a timely manner. Statutes of Canada, Chapter 36, *supra*, note 16.

making the proposal must sign the statement. The amendments should provide greater transparency to the system and provide creditors with more accurate financial information to determine when and whether they want to participate in the process.

The new s. 50(12.1) will specify that where the court declares the proposal deemed refused by the creditors, s. 57, which sets out the consequences of a refusal by creditors, applies as if the proposal had been refused by the creditors.[92] The proposed addition of s. 50.4(7)(c) is intended to add transparency to the system by requiring the trustee to send a report about any material adverse change to creditors without delay after receiving information regarding the change.[93]

The amendments will codify, for the first time, the availability of interim financing during proposal proceedings. Interim financing provides funds to a business in financial distress to enable the business to continue to operate while it attempts to restructure its debts. The most important element is the obtaining of a priority charge by the interim lender in respect of the amount lent, thereby decreasing its risk and increasing the likelihood that a willing lender can be found. While the court in several cases has found the authority to order such financing under its general authority,[94] the amendments clarify that authority and align the provisions with those in the *CCAA.*

Section 50.6 will provide a court with the authority to grant a charge against the property of a debtor in respect of interim financing, subject to certain limits. In deciding whether to make an order, the court is to consider, among other things, the period during which the debtor is expected to be subject to *BIA* proceedings*;* how the debtor's business and financial affairs are to be managed during the proceedings; whether the debtor's management has the confidence of its major creditors; whether the loan would enhance the prospects of a viable proposal; the nature and value of the debtor's property; whether any creditor would be materially prejudiced as a result of the security or charge; and the trustee's views. These criteria are essentially a codification of the factors previously used by the court in determining applications for interim financing.

The *BIA* will also be amended to subordinate equity claims in a proposal.[95] When an investor has been fraudulently misled into investing in a business, and for that reason has suffered a financial loss, that investor has a legal action against the company, the directors and others who were party to the deception. When the company is in financial distress, however, Parliament has decided that such claims against the debtor company should be subordinated to the claims of other creditors. Under reform of section 140.1 of the *BIA,* shareholders with such claims against the company will be explicitly placed at the bottom of the priorities list for recovery of their losses. In a proposal, unlike in bankruptcy that has a set distribution list, payment of claims is based on negotiations between the parties. To reduce the power of equity claimants, the reform removes the right of such creditors to vote on proposals unless the court orders otherwise.[96] Section 60(1.7) will specify that no proposal that provides for the payment of an equity claim is to

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[92] Statutes of Canada, Chapter 36, *supra*, note 16.

[93] The addition of s. 50.4(8)(b.1) will provide that the official receiver does not have to rely on the trustee's report before issuing the certificate of assignment.

[94] See, for example, *Re Bearcat Explorations Ltd.* (2004), 3 C.B.R. (5th) 167 (Alta Q.B.).

[95] See Janis Sarra, "From Subordination to Parity, An International Comparison of Equity Securities Law Claims in Insolvency Proceedings", (2007) International Insolvency Review 1-52.

[96] Proposed s. 54.1.

be approved by the court unless the proposal provides that all claims that are not equity claims are to be paid in full before the equity claim is to be paid.

Proposed s. 60(1.3)(a) will ensure that unpaid wage claims are satisfied in a proposal. The provision will require that a court refuse to approve a proposal unless the proposal provides for the payment of wage claims immediately after court approval of the proposal of amounts at least equal to their preference under s. 136(1)(d) of the *BIA*. Wage earners in proposals are not entitled to payment under the new Wage Earner Protection Program (WEPP) because the program only contemplates payments in the case of bankruptcy or receivership of the employer.[97] The reform ensures consistency of treatment between wage earners whose employer becomes bankrupt or is put into receivership and wage earners whose employer undergoes a restructuring.

The amendments create a new priority for specified claims related to pensions that must be included in a proposal. When a debtor undertakes a restructuring under the proposal provisions of the *BIA*, debts, including those owed to a pension fund, may be compromised. Yet pension rights can form a significant portion of a wage earner's compensation from the employer, although it is deferred income. For wage earners, a diminution of pension benefits can have a negative impact on future income levels. The reform is aimed at providing a higher priority for unremitted pension contributions. The amounts subject to the priority are: contributions deducted from employees' salaries but not remitted to the pension fund, contributions owed by an employer for the cost of benefits offered under the pension plan, excluding amounts payable to reduce an unfunded pension liability, and contributions owed by an employer to a defined contribution plan.[98]

If an unfunded pension liability exists and a claim is made, it is treated as an unsecured debt. Because court approval will be required before a Division I proposal is finalized, prohibiting a court from approving any proposal that does not require the payment of unremitted pension contributions described above effectively grants a super-priority to the pension contribution amounts. The super-priority, however, will be limited by the operation of s. 60(1.6), which provides flexibility for the court to allow for a compromise of pension contribution obligations where the parties agree and the pension regulator approves. It is expected that the provision will be used in limited circumstances.[99]

In a proposal proceeding, unlike in a bankruptcy, the directors retain control of the debtor's assets and also development of the proposal that will be put to the creditors. In this role, directors may positively or negatively affect the restructuring

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[97] The *Wage Earner Protection Act* was part of the insolvency law amendments that came into force July 7, 2008, Statutes of Canada, c. 36, (only partly in force).

[98] Obligations relating to unfunded pension liabilities, including special payments or solvency payments ordered to be paid by a regulator but not remitted to the pension fund, were not given a higher priority.

[99] The proposed amendments to sections 50 to 62 are aimed at encouraging debtors to use the proposal provisions of the *BIA*. The amendment to s. 62(1) is intended to clarify the documents that have to be filed with the official receiver by the trustee. The amendment to s. 62(2) and the addition of s. 62(2.1) are intended to ensure that s. 178 protection is lost only if the creditor votes in favour of the proposal and the proposal explicitly provides for the compromise of the s. 178 claim. The potential has existed for s.178 creditors to inadvertently release claims by accepting a proposal; the new wording in s. 62(2.1) is aimed at correcting any ambiguity. The nature of pension regulation in Canada also affects aspects of the section; pensions may be regulated federally or provincially and the section captures pensions described in both federal and provincial legislation.

process, although in most cases, the information they possess regarding the history and operation of the company is invaluable in terms of potentially assisting in devising a viable restructuring plan. Under corporate law, directors have a fiduciary duty to act in the best interest of the corporation, although remedies under this obligation can be untimely or difficult to enforce. Proposed amendments to the *BIA* are aimed at quickly addressing problematic situations. Specifically, proposed s. 64(1) specifies that the court, on the application of any interested person, may make an order removing a director from office if the court is satisfied that the director is unreasonably impairing or is likely to unreasonably impair the possibility of a viable proposal being made in respect of the debtor or is acting or likely to act inappropriately as a director in the circumstances. The court will be granted the authority to fill any vacancy created by an order made under s. 64(1).[100]

The proposed amendments will also codify the court's ability to order indemnification for directors during proposal proceedings. Directors are confronted with statutorily created personal liability, including for unpaid wages and taxes, when the business they are engaged by suffers financial difficulties. Some statutory liabilities provide for a due diligence defence, but not all. There is a risk that directors will resign rather than accept additional potential liability, leaving the business without experienced direction when it most needs it. The purpose of the reform is to provide directors and officers with greater protection against personal liability that may arise due to circumstances beyond their control in an insolvency proceeding, by providing them with indemnification under specific circumstances. More directors may be willing to continue to act, thereby increasing the potential for successful restructuring.

Pursuant to proposed s. 64.1(1), the court will have authority to make an order declaring that all or part of the property of the debtor is subject to a security or charge in favour of any director or officer. The security or charge is to indemnify the director or officer against obligations and liabilities arising after the filing of the notice of intention or the proposal. The court may not make the order if, in its opinion, the debtor could obtain adequate indemnification insurance for the director or officer at a reasonable cost. The court may order that the security or charge ranks in priority over the claim of any secured creditor.[101] The court is to make an order declaring that the security or charge does not apply in respect of a specific obligation or liability incurred by a director or officer if, in its opinion, the liability was incurred as a result of the director's or officer's gross negligence or wilful misconduct or, in Québec, the director's or officer's gross or intentional fault.[102]

Section 64.2 of the *BIA* will be added to allow for effective participation of interested stakeholders, either directly, if they are large creditors, or indirectly as part of a creditors' group or stakeholders' group in proposal proceedings. The court will have authority to grant certain parties a priority charge over the assets of a debtor if the court determines it is necessary for effective participation in the proposal proceedings.[103] The court will have authority to order that the security or

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[100] Proposed s. 64(2), *BIA*.
[101] Proposed s. 64.1(2), *BIA*.
[102] Proposed s. 64.1(4), *BIA*.
[103] Statutes of Canada, Chapter 36, *supra*, note 16; proposed s. 64.2(1), *BIA*. The court may make an order declaring that all or part of the debtor's property is subject to a security or charge, in an amount that the court considers appropriate, in respect of the fees and expenses of (*a*) the trustee, including the fees and expenses of any financial, legal or other experts engaged by the trustee in the performance of its duties; (*b*) any financial, legal or other experts engaged by the person for the purpose of proceedings; and (*c*) any financial, legal or other experts engaged by any other interested person if the court is satisfied that the

charge rank in priority over the claim of any secured creditor of the debtor.[104] The court may not make the order in respect of an individual debtor unless the individual is carrying on a business; and only property acquired for or used in relation to the business may be subject to a security or charge.[105]

Amendment to s. 65.1(1) of the *BIA*, effective July 7, 2008, clarified that the protection against the impact of *ipso facto* clauses, which purport to entitle the termination of an agreement on the basis of the filing of a notice of intention or a proposal, also applies to security agreements.[106] This change should end potential abuse of *ipso facto* clauses, where contracts may be cancelled only because of the insolvency filing, and not for any breach in performance of the contract.

When a debtor enters the restructuring process under the *BIA* proposal provisions, it does so in order to seek a reduction of its debts and obligations. Among the obligations that the debtor may seek to renegotiate are ongoing agreements. Proposed section 65.11 is aimed at allowing debtors to be freed from burdensome agreements that make up part of the financial distress experienced by the debtor and which may be a barrier to a successful restructuring. In accordance with the reforms, the debtor will be able to unilaterally terminate or disclaim agreements, subject to specific limitations.[107]

Under the proposed revisions to proposal proceedings, certain agreements may not be unilaterally disclaimed by the debtor, including eligible financial contracts; collective agreements; financing agreements if the debtor is the borrower; or a lease of real property or of an immovable if the debtor is the lessor.[108]

Third parties will have the right to challenge a disclaimer by application to the court.[109] The amendments set out the factors the court is to consider in determining whether or not to grant the declaration, specifically, whether the trustee approves of it; whether the disclaimer or resiliation would enhance the prospects of a viable proposal; and whether it would likely cause significant financial hardship to a party to the agreement.[110] An agreement is disclaimed or resiliated if no application is made 30 days after the debtor gave notice; or if the court dismisses an application after the same period or any later day fixed by the court; or if the court orders that the agreement is disclaimed or resiliated.[111]

If the debtor has granted a right to use intellectual property to a party to an agreement, the disclaimer or resiliation will not affect the party's right to use the intellectual property, including the party's right to enforce exclusive use during the term of the agreement for any period for which the party extends the agreement as of right, as long as the party continues to perform its obligations under the agreement in relation to the use of the intellectual property.[112]

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security or charge is necessary for the effective participation of that person in the proceeding.

[104] *Ibid.,* proposed s. 64.2(2), *BIA*.
[105] *Ibid.,* proposed s. 64.2(3), *BIA*.
[106] Statutes of Canada, Chapter 36, *supra*, note 16.
[107] *Ibid.,* proposed s. 65.11, *BIA*.
[108] *Ibid.,* proposed s. 65.11(2), *BIA*.
[109] *Ibid.,* proposed s. 65.11(3), *BIA*.
[110] *Ibid.,* proposed section 65.11(5), *BIA*.
[111] *Ibid.,* proposed section 65.11(6), *BIA*.
[112] *Ibid.,* proposed s. 65.11(7), *BIA*.

If an agreement is disclaimed or resiliated, the party who suffers a loss in relation to the disclaimer or resiliation is considered to have a provable claim.[113] A debtor must, on request by a party to the agreement, provide in writing the reasons for the proposed disclaimer or resiliation within five days after the day on which the party requests them.[114]

For unionized insolvent debtor companies, there are also new provisions for collective bargaining during a proposal proceeding, aimed at creating certainty for unionized workers and debtor companies that are unionized. A debtor may apply to the court for an order authorizing the debtor to serve a "notice to bargain" under applicable provincial or federal labour laws to the union's bargaining agent.[115]

Proposed amendments are aimed also at providing the debtor with greater flexibility in dealing with its property while limiting the possibility of abuse. A debtor filing a proposal or notice of intention may not sell or otherwise dispose of assets outside the ordinary course of business unless authorized to do so by a court.[116] The court will be able to authorize the sale or disposition even if shareholder approval was not obtained. In the case of an individual who is carrying on a business, the court may authorize the sale or disposition only if the assets were acquired for or used in relation to the business.

Applications under this section will require notice to the secured creditors that are likely to be affected by the proposed sale or disposition. In deciding whether to grant the authorization, the court is to consider, among other factors, whether the process leading to the proposed sale or disposition was reasonable in the circumstances; whether the trustee approved the process leading to the proposed sale or disposition; whether the trustee filed with the court a report stating that in its opinion the sale or disposition would be more beneficial to the creditors than a sale or disposition under a bankruptcy; the extent to which the creditors were consulted; the effect on the creditors and other interested parties; and whether the consideration to be received for the assets is reasonable and fair, taking into account their market value.[117]

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[113] *Ibid.,* proposed s. 65.11(8), *BIA*.

[114] *Ibid.,* proposed s. 65.11(9), *BIA*.

[115] *Ibid.,* proposed s. 65.12(1), *BIA*. A court order will be required because labour law stipulates specific periods when a notice to bargain may be served. Subsection (2) sets out the conditions that must be met before a court may grant the order. Under the proposed amendments, the debtor may continue to negotiate with other parties and may prepare a proposal to bring to its creditors before the time periods set out in the relevant labour law expire. Subsection (3) will provide that the vote of the creditors in respect of the proposal may not be delayed solely because the period provided under the relevant collective bargaining process has not expired. Subsection (6) will clarify that the existing collective agreement remains in force unless the debtor and the bargaining agent have agreed to revise its terms. Section 65.12(4) will provide the bargaining agent with a claim against the debtor for the value of any concessions granted during negotiations with the debtor. The claim would be as an unsecured creditor. Section 65.12(5) will provide that a bargaining agent may apply to the court for an order compelling a person with information regarding the debtor's business and financial affairs to provide that information to the bargaining agent that is relevant to the collective bargaining. Section 65.12(6) is intended to clarify that the court does not have the authority to unilaterally impose an amended collective agreement on the parties.

[116] *Ibid.,* proposed s. 65.13, *BIA*.

[117] Proposed s. 65.13(4), *BIA*.

Proposed section 65.13(5) will address the situation where the proposed sale is to a related person. If the proposed sale or disposition is to a person who is related to the insolvent debtor, the court may, after considering the above-noted factors, grant the authorization only if it is satisfied that good faith efforts were made to sell or otherwise dispose of the assets to persons who are not related to the insolvent person; and the consideration to be received is superior to the consideration that would be received under any other offer made in accordance with the process leading to the proposed sale or disposition. For purposes of this section, a related person will include a director or officer of the debtor, a person who has or has had, directly or indirectly, control in fact of the debtor, and any person who is related to any of these people.

The court may authorize a sale or disposition free and clear of any security, charge or other restriction and, if it does, it is to order that other assets of the debtor or proceeds of the sale or disposition are subject to a security, charge or other restriction in favour of the creditor whose security, charge or other restriction is to be affected by the order.[118] The court may grant the authorization only if the court is satisfied that the debtor can and will make the payments that would have been required under ss. 60(1.3)(a) for wage claims and (1.5)(a) for specified pension claims if the court had approved the proposal.[119]

The amendments are designed to facilitate business proposals while offering some fundamental protections for creditors from potential abuses of proposal proceedings. As of March 31, 2009, they are not yet proclaimed in force.

IV. BUSINESS INSOLVENCY IN CANADA

It is helpful to provide an overview of business insolvency before turning to particular data generated by the study. Equally, it is important to place the number of failed businesses in perspective, in terms of the percentage of businesses that fail compared with the total number of businesses operating in Canada.

1. Overview

The Business Register of Statistics Canada maintains a count of business establishments, which must meet at least one of the following minimum criteria: the business must have at least one paid employee with payroll deductions remitted to the Canada Revenue Agency; it must have annual sales revenues of $30 000; or it must be incorporated and have filed a federal corporate income tax return at least once in the previous three years. As of June 2008, there were more than 2.3 million business establishments in Canada. That figure serves as an important backdrop for considering the 7,445 business insolvencies in the past year.

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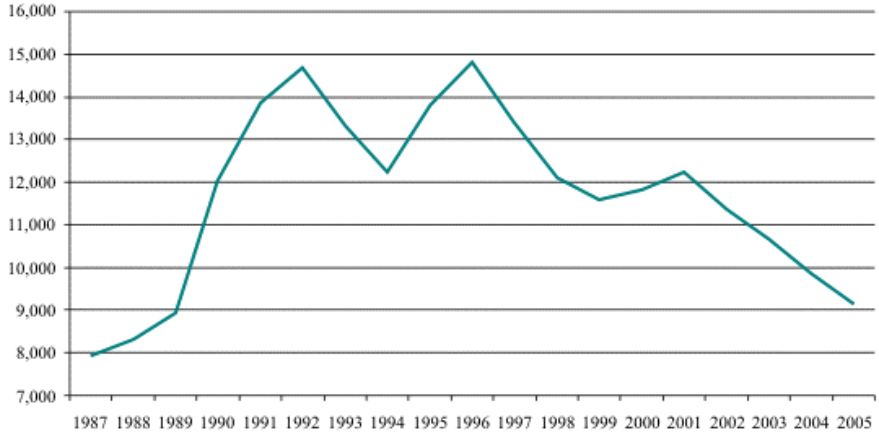
[118] Proposed s. 65.13(7), *BIA*.

[119] Proposed s. 65.13(8), *BIA*. Pursuant to proposed section 66(1.1), in deciding whether to make an order under subsection 84.1(1), the court is to consider, in addition to the factors referred to in subsection 84.1(3), whether the trustee approved the proposed assignment. When proclaimed in force, proposed section 66(1.3) will specify that for the purposes of subsection (1), the examination under oath by the official receiver is to be held, on the attendance of the person in respect of whom a notice of intention or a proposal is filed, before the proposal is approved by the court or the person becomes bankrupt.

Business insolvencies followed an upward trend until the late 1980s, and since the early 1990s, the trend has been the reverse.[120] As illustrated by Graph 1 below, there were 7,900 business insolvencies in 1987. The OSB reports that the recession of 1990-1992 increased that number to 14,700 in 1992; then the economic recovery reduced the number of filings with the OSB to 12,200 in 1994.[121] Business insolvencies increased to a peak of 14,800 in 1996, and have declined fairly steadily since that time.[122] In 2005, 9,100 business insolvencies were filed with the OSB, representing a decrease of 39% from the peak in 1996.[123] As noted in the introduction, that figure declined further to 7,612 in 2007 and 7,445 in 2008. This trend is shifting as the recessionary aspects of the financial crisis continue to deepen in 2009.

Graph 1
Business insolvency, Canada 1987-2005,
Office of Superintendant of Bankruptcy



Another trend is that the number of restructuring proposals grew until a peak in 2003, at which point there was a decline. The number of business proposals increased an average of 14% each year from 1993 to 2002, almost equally divided between corporations and individual businesses.[124] The decline of bankruptcies in relation to restructuring proposals makes sense, given that since the 1992 and 1997 amendments to the *BIA,* the public policy priority has been to try to rehabilitate insolvent businesses. One objective of the *BIA* reform in 1992 was to promote business proposals as an alternative to bankruptcy by introducing measures to improve the viability of business proposals and facilitate their acceptance by creditors.[125] The OSB reported in early 2007 that approximately

[120] *Business Insolvency in Canada: a National and Regional Analysis for the Period 1987-2005*, OSB, December 2006, http://strategis.ic.gc.ca/epic/site/bsf-osb.nsf/vwapj/BusinessInsolvencyCanada1987-2005.pdf/$FILE/BusinessInsolvencyCanada1987-2005.pdf.
[121] *Ibid.*
[122] *Ibid.*.
[123] *Ibid.*
[124] *Ibid.*
[125] *Ibid.*

one of every two business proposals will fail and become a bankruptcy, noting that this proportion can vary a great deal from one economic sector to another.[126]

Looking at the most recent available global data, the OSB reports that the number of business insolvencies decreased in 2008 by 2.2% from the year prior, while the total number of all insolvencies increased by 13.2% in the same period, indicating that the increase was largely in consumer insolvency nationally.[127] The number of business bankruptcies declined by 2% and the number of business proposals by 2.9%. The figures indicate a slowing of the general decline in business insolvencies, compared with the same figures 6.6% and 7.4% respectively the year prior. Even though the number was not yet on the rise in 2008, this pattern appears to be shifting in 2009.

The OSB also reports that the number of corporations that filed under the *BIA* remained relatively stable between 2006 and 2007, whereas the number of sole proprietors filing decreased by almost 10%. Table 1 illustrates the changes in total numbers of filings between 2006 and 2007. Figures are not yet available for 2008.

Table 1

Insolvency, Canada 2006—2007, OSB Annual Report			
	2006	**2007**	**Change**
Total insolvencies (business and consumer)	106,629	108,830	2.1%
Business insolvency	8,179	7,624	-6.8%
Business bankruptcies	6,756	6,307	-6.6%
Proposals	1,423	1,317	-7.4%
Insolvent corporations	2,494	2,499	0.2%
Insolvency sole proprietorships	5,685	5,125	-9.9%

In Table 1 above, proposal numbers include Division I proposals filed by corporations and sole proprietorships and Division II proposals filed by sole proprietorships. The term "sole proprietorship" is used by the OSB to indicate a non-incorporated business as opposed to a corporation. Hence, a partnership may be included in non-incorporated businesses, or, in the case of an incorporated joint venture, in the corporation category.

2. Regional Variations

There are considerable variations regionally in respect of business insolvency. Examining business bankruptcy by region, Ontario and Québec had the greatest number by far, accounting for 75% of all business insolvencies in Canada in 2008, as reflected in Table 2 below.[128] Table 2 illustrates business insolvencies by province and territories.

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[126] *Ibid.*

[127] OSB, *Insolvency Statistics in Canada, Fourth Quarter of 2008,* http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng.html.

[128] OSB, *Annual Statistical Report*, 2008, http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br02118.html, at table 4.

In 2008, business insolvencies increased by 6.7% in Québec over the previous year; by 32.8% in New Brunswick; and 33.3% in the Yukon, although the number of insolvencies is very small in the Yukon. The number of business insolvencies declined in all other provinces in relation to the year prior. In 2007, Québec was the only region in Canada that witnessed an increase in business insolvencies over the year prior, with a rise of 8.8%. In terms of assets and liabilities, bankrupt insolvencies in Ontario have significantly higher amounts, compared with Québec, as indicated in Table 2. While the number of insolvent estates in the two provinces was similar at 2,711 and 2,852 in Québec and Ontario respectively, the total assets implicated in Ontario business insolvencies were almost double those in Québec and the liabilities more than double. While British Columbia and Alberta respectively had 6.7% and 5.4% fewer insolvencies than the year prior, the comparable figures were 18.6% and 32.9% respectively in 2007 indicating a reverse in the trend of fewer financially distressed businesses.

In terms of bankruptcies, Ontario and Québec also led the country. While fewer businesses filed for bankruptcy by number in British Columbia, overall, that province had higher total net liabilities. Alberta had a comparable number of business insolvencies, but fewer assets and liabilities than in British Columbia.

While there was a significant decline in the number of business insolvencies in the Yukon, Newfoundland and Labrador and Nunavut, the numbers are so small as not to be statistically significant for the country. Saskatchewan had 25.2% fewer business insolvencies, with 205 in 2008. Nova Scotia also experienced a decline of 15.4% over the previous year, at 193 business insolvencies in 2008. The mean and median amounts of assets and liabilities for the overall totals are not available, however, the project was able to calculate them for the 5,515 cohort, discussed below.

Table 2
Business Insolvencies by Regions, 2008
Office of the Superintendent of Bankruptcy[129]

	Volume			2008	
	2008	**2007**	**% Change**	**Assets Declared at the Time of Filing ($)**	**Liabilities Declared at the Time of Filing ($)**
Newfoundland and Labrador	**40**	**54**	**-25.9**	**12 767 894**	**179 361 670**
Bankruptcies	39	52	-25.0	12 767 894	179 361 670
Proposals	1	2	-50.0	0	0
Prince Edward Island	**20**	**37**	**-45.9**	**1 294 574**	**6 297 400**
Bankruptcies	14	32	-56.3	600 173	3 091 730
Proposals	6	5	20.0	694 401	3 205 670
Nova Scotia	**193**	**228**	**-15.4**	**23 006 568**	**85 139 048**
Bankruptcies	162	206	-21.4	18 597 810	77 367 711
Proposals	31	22	40.9	4 408 758	7 771 337
New Brunswick	**243**	**183**	**32.8**	**22 522 337**	**77 734 811**
Bankruptcies	196	151	29.8	16 328 680	61 776 495

[129] *Ibid.*

Proposals	47	32	46.9	6 193 657	15 958 316
Quebec	**2 711**	**2 541**	**6.7**	**396 340 825**	**1 713 931 879**
Bankruptcies	2 157	2 035	6.0	290 258 586	987 098 968
Proposals	554	506	9.5	106 082 239	726 832 911
Ontario	**2 852**	**3 041**	**-6.2**	**672 360 121**	**4 687 564 156**
Bankruptcies	2 437	2 585	-5.7	602 480 360	4 272 086 325
Proposals	415	456	-9.0	69 879 761	415 477 831
Manitoba	**112**	**112**	**0.0**	**28 923 636**	**77 390 016**
Bankruptcies	103	102	1.0	28 082 240	76 428 757
Proposals	9	10	-10.0	841 396	961 259
Saskatchewan	**205**	**274**	**-25.2**	**56 910 210**	**114 943 032**
Bankruptcies	150	204	-26.5	34 461 963	71 480 733
Proposals	55	70	-21.4	22 448 247	43 462 299
Alberta	**524**	**554**	**-5.4**	**163 644 771**	**669 345 457**
Bankruptcies	447	449	-0.4	154 499 538	639 596 209
Proposals	77	105	-26.7	9 145 233	29 749 248
British Columbia	**540**	**579**	**-6.7**	**263 290 240**	**783 852 349**
Bankruptcies	454	470	-3.4	242 536 823	704 104 448
Proposals	86	109	-21.1	20 753 417	79 747 901
Northwest Territories	**1**	**4**	**-75.0**	**11 300**	**44 100**
Bankruptcies	1	2	-50.0	11 300	44 100
Proposals	0	2	-100.0	0	0
Yukon	**4**	**3**	**33.3**	**236 842**	**765 105**
Bankruptcies	4	3	33.3	236 842	765 105
Proposals	0	0	—	0	0
Nunavut	**0**	**2**	**-100.0**	**0**	**0**
Bankruptcies	0	2	-100.0	0	0
Proposals	0	0	—	0	0
Canada	**7 445**	**7 612**	**-2.2**	**1 641 309 318**	**8 396 369 023**
Bankruptcies	**6 164**	**6 293**	**-2.0**	**1 400 862 209**	**7 073 202 251**
Proposals	**1 281**	**1 319**	**-2.9**	**240 447 109**	**1 323 166 772**

The regional breakdown of insolvent businesses can be compared with the regional breakdown of all businesses operating in Canada, as Table 3 illustrates, illustrating that a small percentage of businesses in Canada fail financially.[130]

[130] Statistics Canada reports the following: “About half of all business establishments are called "employer businesses" because they maintain a payroll of at least one person (possibly the owner). The other half are classified as "indeterminate" because they do not have any employees registered with the CRA. Such businesses may indeed have no workforce (they may simply be paper entities that nonetheless meet one of

Table 3
Total Number of Business Establishments, and Number of Establishments Relative to Provincial/Territorial Population and Gross Domestic Product, June 2008

Provinces/Territories	No. of Business Establishments			Establishments per 1000 Population	GDP per Business Establishment ($ thousands)
	Total	Employer Businesses	Indeterminate[1]		
Source: Statistics Canada, Business Register, June 2008; National Income and Expenditure Accounts 2007; Estimates of Population by Age and Gender for Canada, the Provinces and the Territories, June 2008. Note 1: The "indeterminate" category consists of incorporated or unincorporated businesses that do not have a Canada Revenue Agency payroll deductions account. The workforce of such businesses may consist of contract workers, family members and/or owners.					
Newfoundland and Labrador	26 861	17 877	8 984	52.8	1 081
Prince Edward Island	10 524	6 021	4 503	75.5	431
Nova Scotia	55 648	30 711	24 937	59.5	598
New Brunswick	42 866	25 987	16 879	57.0	616
Québec	470 130	237 938	232 192	60.7	634
Ontario	904 019	370 134	533 885	70.1	644
Manitoba	75 824	35 090	40 734	63.4	641
Saskatchewan	90 851	36 920	53 931	89.9	563
Alberta	338 642	150 546	188 096	96.4	768
British Columbia	364 540	170 692	193 848	82.3	522
Yukon Territory	2 881	1 571	1 310	91.4	586
Northwest Territories	2 668	1 614	1 054	62.8	1 717
Nunavut	859	618	241	27.6	1 596
Canada Total	**2 386 313**	**1 085 719**	**1 300 594**	**71.8**	**642**

Although not completely comparable, given the way in which Statistics Canada defines business, Tables 2 and 3 illustrate that most businesses continue to operate successfully. For example, less than 1% of all businesses in Ontario and Québec became insolvent in 2008, notwithstanding their comparatively larger numbers of business insolvencies.

The OSB also reports the number of business insolvency cases per thousand businesses in Canada, summarized in Graph 2 below. Nationally, the number of business insolvency cases per thousand businesses was 3.2 cases in 2007, a decrease of 0.3 cases from the previous year.[131] It has not yet reported comparable statistics for 2008.

The Manitoba/Saskatchewan region experienced a significant decrease of 1.2 cases, down to 2.2 business insolvency cases per thousand businesses.[132] British Columbia and Alberta have the lowest number of cases per thousand businesses, with 1.6 and 1.7 business insolvency cases per thousand respectively.

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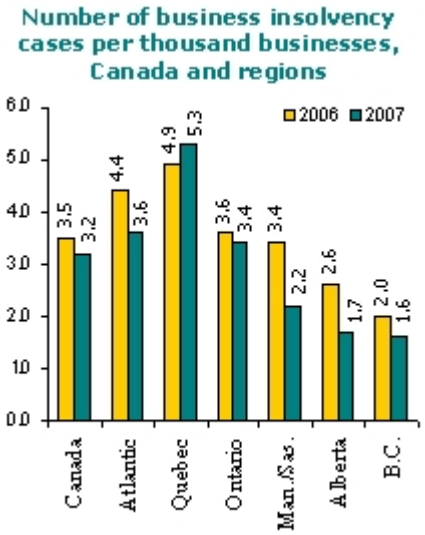
the criteria for recognition as a business establishment) or they may have contract workers, family members and/or only the owners working for them. The "indeterminate" category was created because information about their workforce is not available", http://www.ic.gc.ca/eic/site/sbrp-rppe.nsf/eng/rd02343.html.

[131] *Ibid.*

[132] *Ibid.*

Québec was the only province with an increase over the previous year, with 5.3 cases per thousand businesses in 2007.[133] Thus there is a shift in the number of failed businesses as a percentage of total businesses, with Québec experiencing the greatest number of business failures based on the number of businesses in that region overall. Ontario was relatively stable at 3.4 business failures per thousand businesses in 2007.

Graph 2 [134]



GDP growth and labour market changes could explain some regional differences in both business and consumer insolvency in 2007. The OSB reports that despite a 1.6% increase in employment in Ontario, 64,300 jobs were lost in the manufacturing sector in 2007.[135] It reports that in Québec, employment increased by 2.3% but export-oriented businesses suffered and 43,000 jobs were lost in the manufacturing sector in 2007.[136] In the other four major regions, the OSB observes that economic growth was largely fuelled by the high price of raw commodities. Employment grew by 4.7% and 3.2%, respectively, in Alberta and British Columbia.[137] In 2007, the unemployment rate was less than 5.0% in the three western regions, while it was more than 6.0% in the three eastern regions.[138]

Examining business insolvencies over a longer timeline, in the graph below, the OSB reports on the number of business insolvencies per thousand businesses from 1998 to 2006 by major region. These data do not align particularly with the Statistics Canada data above, given that they define businesses differently.

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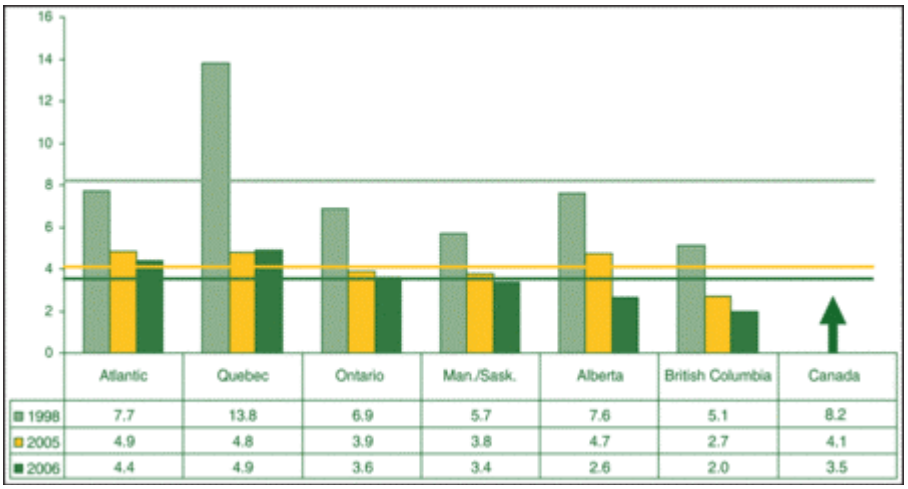
[133] *Ibid.*
[134] OSB, *Insolvency in Canada in 2007,* at 2, http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br01783.html.
[135] OSB, *Insolvency in Canada in 2007*, http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br01783.html, at 2.
[136] *Ibid.*
[137] *Ibid.*
[138] *Ibid.*

The OSB reports that the number of business insolvencies per thousand businesses in Canada dropped from 8.2 in 1998 to 3.5 in 2006. During this period, the ratio decreased in all provinces. In Québec, there was a significant decrease observed between 1998 and 2006, with the ratio declining from 13.8 cases per thousand businesses, which was the highest in Canada at the time, to 4.9 cases. In 2006, Québec was still the region with the highest ratio; followed by the Atlantic region at 4.4, Ontario at 3.6, Manitoba/Saskatchewan at 3.4, and Alberta at 2.6. British Columbia was the region with the lowest ratio in Canada with 2.0 business insolvencies per thousand businesses. As noted above in Graph 1, Québec's ratio increased to 5.3 in 2007, whereas British Columbia has declined to 1.6 per thousand businesses.

Graph 3
Number of Business Insolvencies per Thousand Businesses and Major Regions of Canada, 1998-2006[139]



	Atlantic	Quebec	Ontario	Man./Sask.	Alberta	British Columbia	Canada
1998	7.7	13.8	6.9	5.7	7.6	5.1	8.2
2005	4.9	4.8	3.9	3.8	4.7	2.7	4.1
2006	4.4	4.9	3.6	3.4	2.6	2.0	3.5

In summary, the figures demonstrate shifting regional patterns of economic growth, largely to the west and away from Ontario and Québec, resulting in a higher rate of business insolvencies in those jurisdictions. However, all of these figures are likely to change in 2009, as trustees report an exponential growth in business and consumer insolvencies. While the first quarter results are not yet available, the OSB reports that for February 2009, total insolvencies are up by 25.3 over February 2008, with 22.1% more bankruptcies and 37.5% more proposals.[140]

3. Business Insolvency by Major Economic Sector

The OSB has reported business insolvencies by major economic sector, as set out below in Table 4. The summarized data in this part are either 2007 or 2008 data, as the latter is not yet available for some break down of information. Whereas in the previous year, all sectors had a decrease in the number of business

[139] OSB, *supra,* note 100.
[140] OSB, *Insolvency Statistics in Canada, February 2009*; http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br02205.html.

insolvencies over 2006, except manufacturing, which increased by 3.8% in 2007, the 2008 figures illustrate a changing pattern. Mining and oil and gas insolvencies increased by 28.9% over the previous year. Utilities insolvencies, although small in total numbers, increased by the same percentage. Manufacturing insolvencies and transportation and warehousing rose by 4.6% and 10.6% respectively over the previous year. Finance and insurance insolvencies are up more than 13%, education services by 6.3%, information and cultural industries by 6.3%, and public administration by 37.5%, although again, the latter number is small.

Proposals are up considerably in the agricultural, mining, oil and gas, wholesale trade, transportation and warehousing, information and cultural, and professional and technical services categories. The largest amount of liabilities by economic sector is information and culture, likely as a result of the Québecor insolvency, and manufacturing is significant, as is construction, wholesale and retail trade, and finance and insurance.

Table 4
Insolvencies by Major Economic Sector, Canada, 2007-2008 [141]

	Volume			2008	
	2008	2007	% Change	Assets Declared at the Time of Filing ($)	Liabilities Declared at the Time of Filing ($)
Agriculture, Forestry, Fishing and Hunting	**345**	**350**	**-1.4**	**134 785 959**	**305 219 808**
Bankruptcies	277	292	-5.1	115 457 232	264 342 471
Proposals	68	58	17.2	19 328 727	40 877 337
Mining and Oil and Gas Extraction	**49**	**38**	**28.9**	**60 608 700**	**154 543 055**
Bankruptcies	31	27	14.8	58 810 975	146 106 868
Proposals	18	11	63.6	1 797 725	8 436 187
Utilities	**9**	**7**	**28.6**	**595 071**	**6 265 486**
Bankruptcies	7	6	16.7	595 070	5 087 431
Proposals	2	1	100.0	1	1 178 055
Construction	**1 239**	**1 287**	**-3.7**	**307 889 187**	**792 683 814**
Bankruptcies	1 073	1 087	-1.3	286 753 342	724 224 179
Proposals	166	200	-17.0	21 135 845	68 459 635
Manufacturing	**793**	**758**	**4.6**	**420 281 267**	**1 496 798 146**
Bankruptcies	626	585	7.0	362 668 660	1 119 120 475
Proposals	167	173	-3.5	57 612 607	377 677 671
Wholesale Trade	**389**	**386**	**0.8**	**158 327 772**	**732 062 300**
Bankruptcies	296	310	-4.5	133 029 128	592 113 547
Proposals	93	76	22.4	25 298 644	139 948 753
Retail Trade	**989**	**1 083**	**-8.7**	**131 476 379**	**971 962 988**

[141] OSB, *Insolvency in Canada in 2008,* at table 4, http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br02119.html.

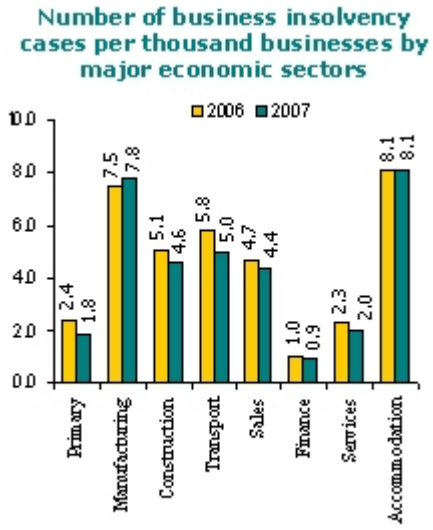
Bankruptcies	837	900	-7.0	110 781 835	777 173 160
Proposals	152	183	-16.9	20 694 544	194 789 828
Transportation and Warehousing	**783**	**708**	**10.6**	**88 150 056**	**369 496 017**
Bankruptcies	652	601	8.5	67 419 355	198 603 535
Proposals	131	107	22.4	20 730 701	170 892 482
Information and Cultural Industries	**134**	**126**	**6.3**	**12 299 112**	**1 867 629 596**
Bankruptcies	101	101	0.0	8 313 291	1 812 807 696
Proposals	33	25	32.0	3 985 821	54 821 900
Finance and Insurance	**119**	**105**	**13.3**	**23 528 732**	**559 753 639**
Bankruptcies	102	87	17.2	16 705 276	489 023 115
Proposals	17	18	-5.6	6 823 456	70 730 524
Real Estate and Rental and Leasing	**162**	**183**	**-11.5**	**54 013 536**	**156 625 259**
Bankruptcies	132	155	-14.8	41 553 365	113 820 870
Proposals	30	28	7.1	12 460 171	42 804 389
Professional, Scientific and Technical Services	**472**	**485**	**-2.7**	**64 567 180**	**209 983 788**
Bankruptcies	372	399	-6.8	41 087 312	151 795 420
Proposals	100	86	16.3	23 479 868	58 188 368
Management of Companies and Enterprises	**43**	**52**	**-17.3**	**7 336 211**	**149 883 751**
Bankruptcies	31	36	-13.9	6 382 841	141 291 040
Proposals	12	16	-25.0	953 370	8 592 711
Administrative and Support, Waste Management and Remediation Services	**301**	**336**	**-10.4**	**21 016 849**	**125 500 096**
Bankruptcies	256	274	-6.6	17 638 025	117 982 598
Proposals	45	62	-27.4	3 378 824	7 517 498
Educational Services	**51**	**48**	**6.3**	**4 080 368**	**18 740 179**
Bankruptcies	39	36	8.3	2 961 012	16 416 868
Proposals	12	12	0.0	1 119 356	2 323 311
Health Care and Social Assistance	**91**	**94**	**-3.2**	**18 050 133**	**56 946 574**
Bankruptcies	72	71	1.4	14 627 602	49 143 655
Proposals	19	23	-17.4	3 422 531	7 802 919
Arts, Entertainment and Recreation	**139**	**172**	**-19.2**	**11 499 499**	**38 798 676**
Bankruptcies	116	145	-20.0	10 351 318	29 866 685
Proposals	23	27	-14.8	1 148 181	8 931 991
Accommodation and Food Services	**865**	**867**	**-0.2**	**82 771 903**	**267 675 623**

Bankruptcies	739	728	1.5	72 010 330	226 791 050
Proposals	126	139	-9.4	10 761 573	40 884 573
Other Services (except Public Administration)	**461**	**519**	**-11.2**	**32 556 141**	**99 795 012**
Bankruptcies	394	445	-11.5	26 240 977	81 486 372
Proposals	67	74	-9.5	6 315 164	18 308 640
Public Administration	**11**	**8**	**37.5**	**7 475 263**	**16 005 216**
Bankruptcies	11	8	37.5	7 475 263	16 005 216
Proposals	0	0	—	0	0
Total	**7 445**	**7 612**	**-2.2**	**1 641 309 318**	**8 396 369 023**
Bankruptcies	**6 164**	**6 293**	**-2.0**	**1 400 862 209**	**7 073 202 251**
Proposals	**1 281**	**1 319**	**-2.9**	**240 447 109**	**1 323 166 772**

Examining business failure as a ratio of total businesses in the particular sector for 2007, the most recent data available, accommodation and food services has the highest rate of failure at 8.1 per thousand businesses. Manufacturing had 7.8 insolvencies per thousand businesses. Transportation and communications was also significant at 5.0 insolvencies per thousand businesses, as illustrated in Graph 4 below.

From 2006 to 2007, the number of business insolvency cases per thousand businesses in the sectors in each sector shifted only slightly, with more insolvencies per thousand in manufacturing, and a decrease or the same ratio in all other sectors, as illustrated in Graph 4 below.

Graph 4

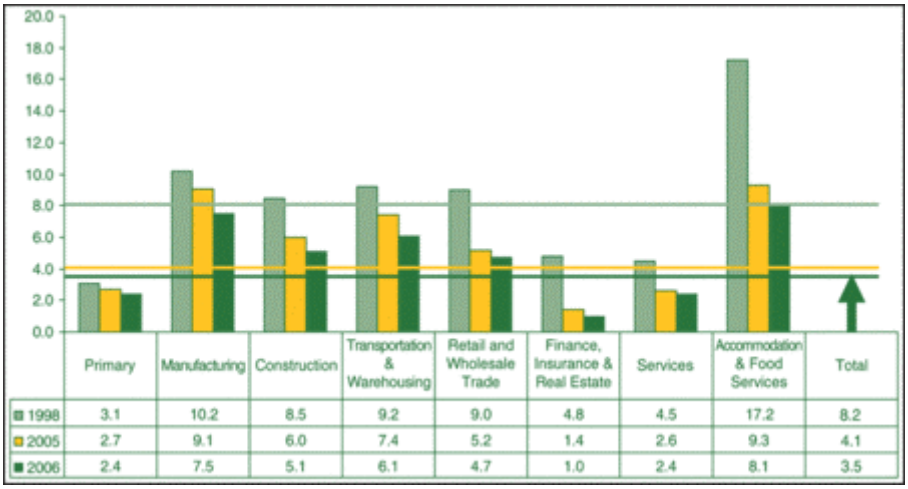


Examining these trends based on overall numbers of businesses in each sector, in the past ten years, the number of business insolvencies per thousand businesses dropped from 8.2 in 1998 to 3.5 in 2006. Graph 5 illustrates this trend. Sectors such as Accommodation and Food Services and Retail and Wholesale Trade posted the greatest decline in insolvency.

In 2006, the Accommodation and Food Services sector and the Manufacturing sector had the highest number of business insolvencies per thousand businesses, with 8.1 and 7.5 respectively. Conversely, Finance, Insurance and Real Estate, Services, and Primary sectors had the fewest business insolvencies per thousand businesses, with 1, 2.4 and 2.4 per thousand businesses respectively.[142]

Graph 5

Business Insolvencies per Thousand Businesses and Major Economic Sector, 1998 to 2006 [143]



	Primary	Manufacturing	Construction	Transportation & Warehousing	Retail and Wholesale Trade	Finance, Insurance & Real Estate	Services	Accommodation & Food Services	Total
1998	3.1	10.2	8.5	9.2	9.0	4.8	4.5	17.2	8.2
2005	2.7	9.1	6.0	7.4	5.2	1.4	2.6	9.3	4.1
2006	2.4	7.5	5.1	6.1	4.7	1.0	2.4	8.1	3.5

Turning to bankruptcy only, as Table 5 below indicates, the greatest number of business bankruptcies by industrial sector in 2007 was in four sectors, construction, retail trade, accommodation and food services, and transportation and warehousing, which together comprised 53% of all business bankruptcies in Canada in 2007.

Table 5
Canada, Business Bankruptcies by Type of Industry[144]

Type of Industry (NAICS)	Number of Cases	Total Assets ($)	Total Liabilities ($)	Total Deficiency ($)

[142] *Ibid.*
[143] OSB, *supra*, note 119.
[144] OSB, Canada, Business Bankruptcies by Type of Industry (NAICS), 2007 calendar year; As per NAICS major groups (1997).

Agriculture, Forestry, Fishing and Hunting	298	53,861,665	208,827,407	154,965,742
Mining and Oil and Gas Extraction	28	5,631,060	45,548,357	39,917,298
Utilities	5	123,106	1,265,860	1,142,755
Construction	1,095	75,692,382	240,841,059	165,148,677
Manufacturing	591	207,537,278	592,484,309	384,947,031
Wholesale Trade	312	84,134,016	325,039,502	240,905,486
Retail Trade	895	97,501,730	346,650,301	249,148,571
Transportation and Warehousing	608	52,862,941	149,962,852	97,099,911
Information and Cultural Industries	92	12,742,252	3,039,165,150	3,026,422,899
Finance and Insurance	87	14,270,149	85,734,388	71,464,240
Real Estate and Rental and Leasing	159	34,210,583	67,121,861	32,911,278
Professional, Scientific and Technical Services	401	21,220,701	132,229,527	111,008,827
Management of Companies and Enterprises	36	6,634,016	45,136,912	38,502,895
Administrative and Support, Waste Management and Remediation Services	270	19,189,031	69,408,998	50,219,968
Educational Services	37	1,136,822	13,704,037	12,567,216
Health Care and Social Assistance	74	9,196,715	21,335,984	12,139,270
Arts, Entertainment and Recreation	146	13,008,671	53,262,254	40,253,583
Accommodation and Food Services	733	43,875,469	164,272,679	120,397,210
Other Services (except Public Administration)	432	31,468,148	111,752,544	80,284,396
Public Administration	8	7,584,216	18,673,672	11,089,456
Total	6,307	791,880,949	5,732,417,654	4,940,536,705

Examining these sector breakdowns by province and territory, in Newfoundland and Labrador, more than half of business bankruptcies were in retail trade, agriculture, fishing and forestry and construction.[145] In Nova Scotia, the greatest number of bankruptcies was in construction, transportation and warehousing and retail trade.[146] In PEI, they were principally in agriculture, forestry, fishing and hunting, and retail trade.[147] In New Brunswick, business bankruptcies were primarily in transportation and warehousing, retail trade and construction.[148]

[145] *Ibid.,* Table 5.
[146] *Ibid.,* Table 5A.
[147] *Ibid.,* Table 5B.
[148] *Ibid.,* Table 5C.

In Québec, the greatest number of bankruptcies was in the retail, manufacturing, construction, accommodation and food services sectors.[149] In Ontario, it was retail, manufacturing, construction, transportation and warehousing, and accommodation and food services sectors, with the heaviest number of bankrupt businesses in retail and construction.[150]

In Manitoba, businesses fail primarily in the agricultural, retail, transportation and warehousing, and accommodation and food services sectors.[151] In Saskatchewan, the principal sectors are agricultural, construction, and accommodation and food services.[152] In Alberta, construction bankruptcies are overwhelmingly the most numerous with 171 in 2007, and transportation and warehousing a distant second with 46.[153] In British Columbia, bankruptcies in the construction and retail trade sectors are most prevalent, and to a lesser amount in manufacturing and transportation and warehousing.[154]

Hence the regional breakdown reflects not only the economic base of the particular province, but also sectors where there has been a downturn in economic activity. However, as the declared causes of insolvency discussed below in Part V suggest, the economic climate is one cause of insolvency, but far from the only factor.

Turning now to global figures on business proposals, the statistics are sometimes opaque. The OSB reports business restructuring in a variety of ways, which do not easily align and thus can be somewhat confusing for comparative purposes. For example, OSB reports total commercial proposals as 3,241 for 2007;[155] and yet reports the number of business proposals as 1,317 for 2007.[156] The OSB explains the differences as follows. In the OSB's *Annual Statistical 2007 Report,* proposals are reported by administrative type, and commercial proposals comprise all Division I and Notice of Intention files regardless of debt type. Consumer Proposals are reported as all Division II, whether involving personal or business debt.[157]

In *Insolvency in Canada in 2007,* proposals are reported by type of debt, business proposals are those with 50% or more business debt, including all Division I corporate files, Division I sole proprietorships, and Division II sole proprietorships.[158] Sole proprietorships are broken down a third way, combining bankruptcies and proposals across both divisions.[159] Hence, one must be careful in interpreting the globally reported data.

Table 6 summarizes total commercial proposals in 2007; however, these figures include individuals who have more consumer than commercial debts, and thus are not useful for this study, but included here for completeness.

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[149] *Ibid.,* Table 5D.
[150] *Ibid.,* Table 5E.
[151] *Ibid.,* Table 5F.
[152] *Ibid.,* Table 5G.
[153] *Ibid.,* Table 5H.
[154] *Ibid.,* Table 5I. The Northwest Territories only had 1 business bankruptcy, the Yukon had 3 and Nunavut had 2.
[155] OSB, Annual Statistical 2007, Table 4 A, http://strategis.ic.gc.ca/eic/site/bsf-osb.nsf/vwapj/annual-report2007.pdf/$FILE/annual-report2007.pdf
[156] OSB, *Insolvency in Canada in 2007.*
[157] Stephanie Cavanaugh, OSB, e-mail correspondence, December 18, 2008.
[158] *Ibid.*
[159] *Ibid.*

Table 6

Total

Province or territory	Total of Estates	Total Assets ($)	Total Liabilities ($)	Total Deficiency ($)
N.L.	24	3,915,332	7,724,392	3,809,060
Nova Scotia	74	2,939,798	16,459,720	13,519,922
P.E.I.	17	4,733,230	5,951,268	1,218,038
New Brunswick	114	11,078,003	28,367,237	17,289,234
Québec	762	231,020,864	788,078,806	557,057,943
Ontario	1,383	290,992,816	686,584,398	395,591,582
Manitoba	47	6,740,684	8,353,656	1,612,972
Saskatchewan	154	31,334,599	40,263,069	8,928,469
Alberta	293	40,320,838	71,725,857	31,405,019
British Columbia	369	50,468,751	136,946,076	86,477,325
N.W.T.	4	743,098	11,501,437	10,758,339
Y.T.	0	0	0	0
Nunavut	0	0	0	0
Canada	3,241	674,288,012	1,801,955,917	1,127,667,904

Commercial Proposals, 2007 [160]

[160] OSB, Table 4-A,Total Commercial Proposals (Reported in the Calendar Year 2007), Annual Report.

In summary, the 6.8% decrease in business insolvencies from 2006 to 2007 was related in part to the favourable economic climate. In 2007, the increase in gross domestic product (GDP) was estimated at 2.6%, a slight drop compared with the increase of 2.8% posted in 2006.[161] The growth in GDP was mainly driven by domestic demand, including consumer expenditures, business investment and government expenditures. In 2007, the Canadian dollar averaged US$0.94, an increase of US$0.05 over the preceding year. While this increase had a negative effect on the manufacturing sector, the OSB has suggested that its effect was positive for the resource sector. The global statistics indicate that business insolvencies are in part a function of overall economic trends, often reflected in terms of the economic base of the particular region of Canada in which the business in located. The construction sector, manufacturing, retail trade, transportation and warehousing, and accommodation and food services tend were the hardest hit in terms of financially distressed businesses in 2008.

In early 2009, trustees report a shift across all sectors, with a sharp rise in insolvency filings. While those figures are not yet available, the OSB monthly statistics for February 2009, indicate that from the previous year, the hardest hit sectors are wholesale trade, up 43%, finance and insurance, up 67%, and real estate, rental and leasing, up by 175% over the previous year.[162] Hence the current financial crisis is having an impact on the number of business insolvencies in 2009, but it is too early to make certain predictions of the extent of the impact on Canadian business.

In the next part, the data are examined in respect of the causes of financial distress for businesses that file proceedings under the *BIA.*

V. CAUSES OF BUSINESS INSOLVENCY

A key objective of the study was to try to discern the causes of insolvency for businesses utilizing the *BIA* bankruptcy or proposal provisions. A better understanding of the causes will allow for greater appreciation of what capital or skills may be required to effect a turnaround of a business or to determine that it should be liquidated and the value of the assets directed to better use.

The data for examining the causes of business insolvency were drawn from a total of 6,743 files: 5,515 full electronic files, 85 representative paper files, 1,143 recently filed proceedings for which only causes of insolvency were available, and 50 trustee surveys. While there were similar trends in the data, the trustee observations added depth and richness to the information. The data are reported here by each of these cohorts, followed by some general observations.

One limitation to analyzing the data was that there were instances in which insolvent debtors listed more than one cause of insolvency, for example, job loss

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[161] OSB, Insolvency in Canada, 2007, http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br01783.html.

[162] OSB, *Insolvency Statistics in Canada, February 2009,* http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br02205.html.

combined with over-extension of credit. For purposes of examining the largest data set of business insolvency files, we took the declared primary cause, but it is important to note that there are frequently synergistic contributions to financial distress that are not captured when reporting global statistics. Hence, we also analysed the top three reported causes where possible, in order to reflect that multiple factors contributed to financial distress of businesses.

1. Summary of Results of Cohort of 5,515 Business Insolvencies

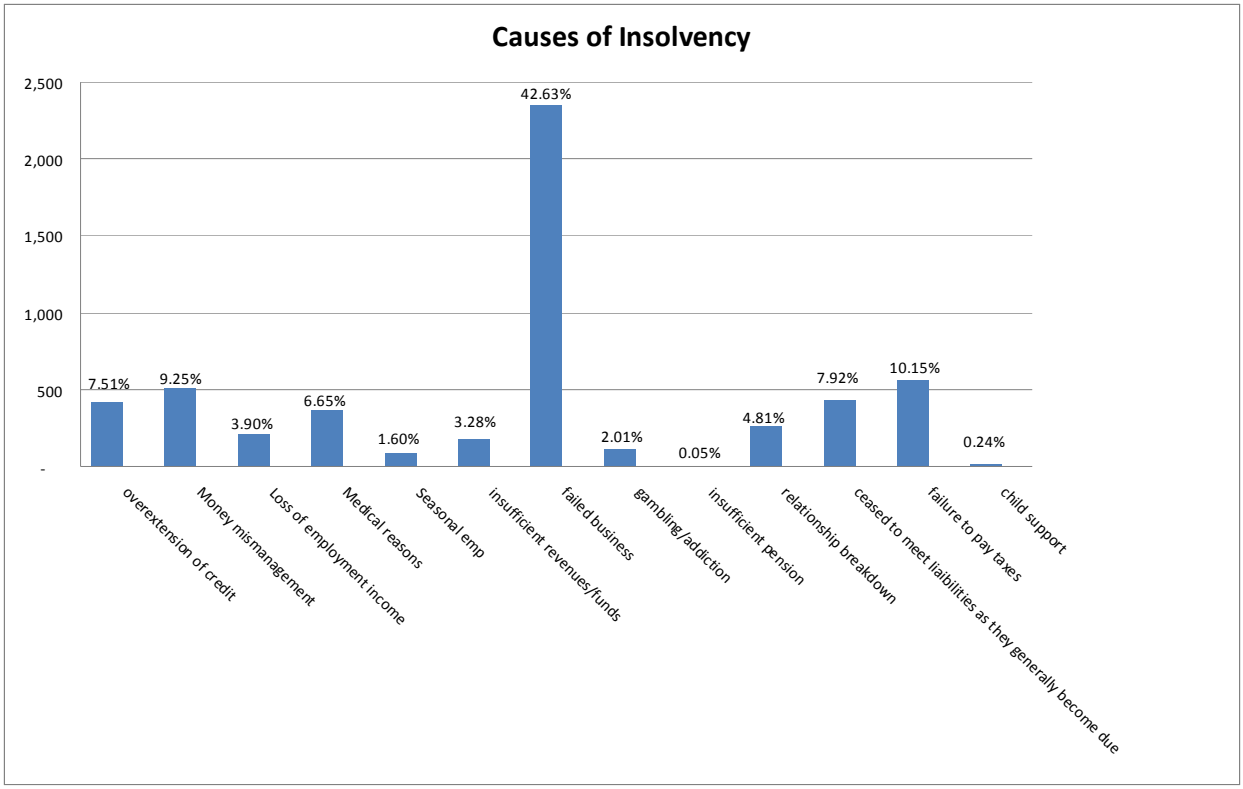
The electronic summary data provide information on causes of bankruptcy for a cohort of 5,515 business insolvencies. The data is keyed into the OSB's data base by hand and is highly descriptive. As noted above, its accuracy is dependent on what the debtor and the trustee or administrator report, and accuracy of what is keyed into the electronic data base; hence, it is not an entirely complete source of information. The information is nevertheless highly instructive as to the causes of bankruptcy.

Graph 6 below highlights the declared reasons for insolvency for the 5,515 electronic files studied. As is no surprise, 42.6% reported that the principal cause of insolvency was a failed business. 9.3% reported mismanagement of money as the primary cause. 7.9% of debtors reported that the primary reason was a failure to be able to pay liabilities as they generally became due. 7.5% of business debtors listed overextension of credit as the primary cause of insolvency.
A significant 10.2% of debtors reported that the primary cause was failure to pay taxes. Although the OSB collects "failure to pay taxes" as a cause of insolvency, it may be more accurately called "the reason for filing the proceeding". One trustee observed that failure to pay GST may be more symptomatic of insolvency rather than a cause, because the tax debt arises from other factors that cause the business to be unable to pay its GST.

Less significant, but notable is that 6.7% of business debtors cited medical reasons as the primary cause of their insolvency. These files indicated that problems most frequently occurred when the sole proprietor became injured or ill and was unable to carry on the business activities; or a key director and officer of a partnership or small corporation was unable to carry on in the business due to a medical problem.

Just less than 5% of business debtors cited relationship breakdown as the primary cause of business insolvency. Here again, the cases appear to involve small businesses where the key principals were married, in a domestic relationship or in a business relationship and the business failed when the relationship had broken down.

Graph 6
Causes of Insolvency of Businesses filing under the *BIA*
5,515 cases, 2006-2008



For this data set, we also analysed the text submitted by the debtors for additional information on the causes of the insolvency given. These data offered greater particularity in respect of the causes of insolvency.

Of the 2,351 files that reported "failed business" as the primary cause of insolvency, 702 files reported additional particulars of the failed business. The study grouped these in broad categories of underlying causes of the failed business, based on the frequency with which they were reported: under capitalization, downturn in the economy, loss of a particular supplier or source of goods, poor management or money mismanagement, failure to adjust to changing business circumstances, over-extension of credit, and failed business relationship where it was cited but as a principal cause. A business may have reported more than one of these as a principal cause and all declared reasons for the 702 file subset are illustrated in Graph 7 below.

Graph 7 indicates that 32% reported poor management of the business as a significant cause of insolvency. Combined with the cases in which it was declared the primary cause, poor management was a principal cause of business insolvency in 735 cases in the large cohort.

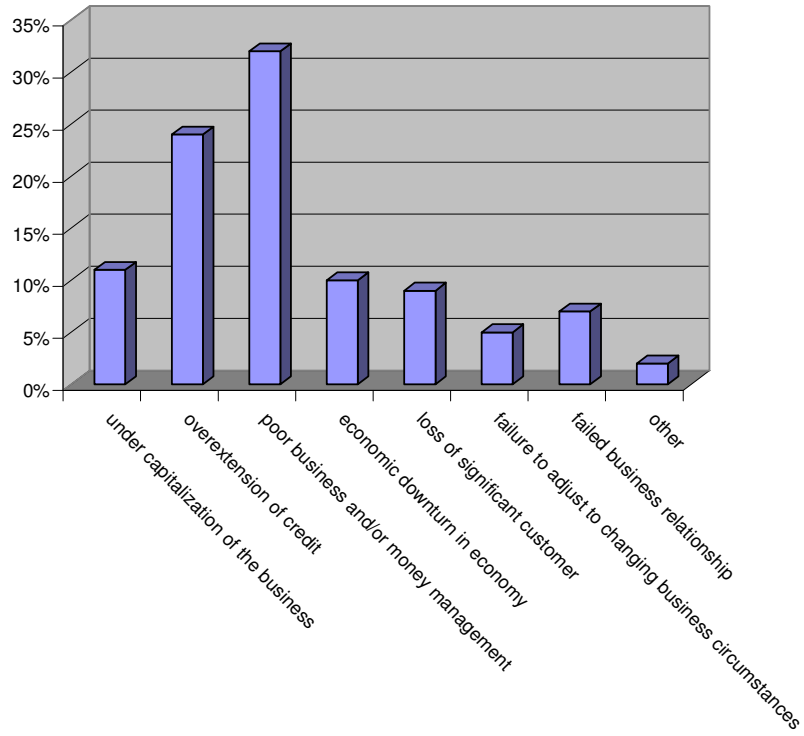
24% reported over-extension of credit as a secondary cause. Again, combined with 7.51% of all files that declared over-extension of credit as the primary cause of insolvency, over-extension of credit is the second principal reason for business failure.

11% declared that the business had been under-capitalized. 10% declared an economic downturn in their sector or the economy. 9% reported loss of a

significant customer as a significant cause. 5% reported failure to adjust to changing business circumstances and 7% reported a failed business relationship.

Graph 7

Secondary Causes of Insolvency where Failed Business Reported as Primary Cause, 702 Cases Reported



Causes in the "other" category for which failed business was declared the primary cause of insolvency included employee theft or fraud, personal guarantees for debt that were called on, debtor or spousal illness or injury, loss of a licence significant to the business, co-signing a loan on a business, and fuel costs. One declared cause was inability by a number of debtors to collect receivables because other businesses associated with the debtor had failed. Other also included business failure due to change in technology and the debtor being slow to react to the need for modernization.

Descriptive comments regarding over-extension of credit repeatedly discussed using consumer and business credit cards to help fund the business or to assist in paying other debts as business declined.

Failed business relationships fell almost exclusively in two categories, a failed partnership, often involving some sort of breach of trust in the debtors' view; and/or a business relationship with a family member and subsequent falling out.

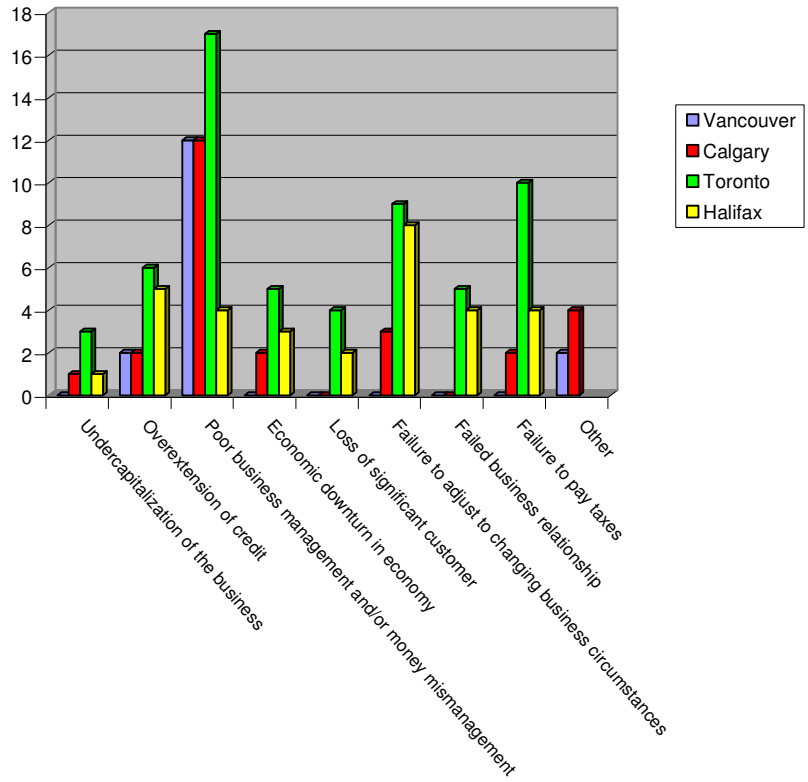
2. Summary of 85 Representative Paper Files

As noted in the introduction, we examined 85 cases in 2007-2008 that were filed as paper files rather than electronic filings, given the OSB's concern that the electronic data may not reflect all those files that continue to be filed in paper form. Graph 8

sets out the causes identified in these paper files, examined in Vancouver, Calgary, Toronto and Halifax.

Graph 8

Principal Causes of Insolvency, Paper files examined



Of the 85 paper files examined, a pattern emerges across the four cities. Poor business management and/or money mismanagement is the most significant cause across all paper files studied. These results align with the larger electronic data set of 5,515 files as the single most significant factor. Failure to pay taxes is significant for Toronto business insolvency filings and to a lesser degree Halifax, and not as a significant reported cause in Vancouver and Calgary. The failure is generally failure to pay GST and similar taxes, as it can often serve as a source of financing as resources of the business become limited. Recall that for the large electronic database, failure to pay taxes was just over 10% of all reported files as the primary cause of insolvency. It may indicate that failure to pay taxes is a more significant issue in some regions than others.

Failure to adjust to changing business circumstances was a significant reported cause in Toronto and Halifax, and to a lesser degree in Calgary. Interestingly, overextension of credit is less significant in the 85 files than for the large cohort, although combined with undercapitalization of the business becomes significant as a source of financial distress. One might have expected economic downturn in the economy to be more significant, although these proceedings were filed during a period of relative economic stability. They can be used as a benchmark to assess the 2008 annual data when it becomes available in June 2009.

The study sought additional information on filings since the most recent financial crisis, in the last quarter of 2008. Of the 1,143 business individuals filing insolvency proceedings during this short period, 191 business debtors cited market collapse or market failure as a primary cause. For corporate filings, the cause of financial difficulty is not recorded where Form 78 is filed electronically and hence this data is not available.

3. Trustee Survey of Causes of Business Insolvency

The study also sought the views of 50 trustees in respect of the causes of business insolvency. Given the limitations of the electronic data, it was hoped that trustees would have a broader perspective and add some depth. Their observations proved quite informative, and generally, most respondents were able to make general observations, not unduly focussing on files that stood out in their memory. One trustee observed, however, that in her view, the declared reasons are not reliable because debtors tend to blame themselves too much for loss of the business and the cause of the sole proprietorship failure cannot be separated out from the personal causes in many cases.

Trustees were first asked about the primary causes, based on OSB reported categories, which do not separate out partnerships. In terms of sole proprietorships, the 50 trustees were asked for the primary cause of insolvency in their experience. Of the trustees surveyed in 2008, 39% reported that poor management or money-mismanagement was the primary cause of business failure in their experience. 29% reported over-extension of credit as the principal cause of business failure in Canada. 8% observed that it was failure to pay taxes. 4% reported that it was economic downturn in the sector as the leading cause. 8% reported that the cause was insufficient income or business revenue. 10% observed that under capitalization had played a significant role in the business' failure. 2% reported that it was the loss of a significant or primary customer.

One trustee's view was that there are fewer actual bankruptcies, as assets are often sold and businesses wound down without accessing the formal bankruptcy process.

In terms of incorporated businesses, trustees reported that the primary cause of insolvency in 29% of cases is poor management or money mismanagement. 21% reported that insufficient business revenue is the primary cause. 19% of business insolvencies are attributable to a downturn in the economy. 11% of trustee reported that it was due to failure to pay taxes; 9% due to overextension of credit; 6% due to a failed business relationship; 3% due to under-capitalization and 2% loss of a significant customer.

Given that there are frequently multiple causes of insolvency, the trustees were also asked to reflect on three principal causes of business failure, distinguishing between sole proprietorships, partnerships and incorporated businesses. Their responses reflected in Graphs 9 to 11 below.

For sole proprietors, poor management or money mismanagement is a very significant cause of financial distress, in that 72% of trustees surveyed observed that this factor plays a significant role in the insolvency. This figure is considerably higher than is evident in the declared causes in the large cohort, suggesting that enhanced counselling on business management may be a policy option for the future. 33% reported that under-capitalization of the sole proprietor's business was

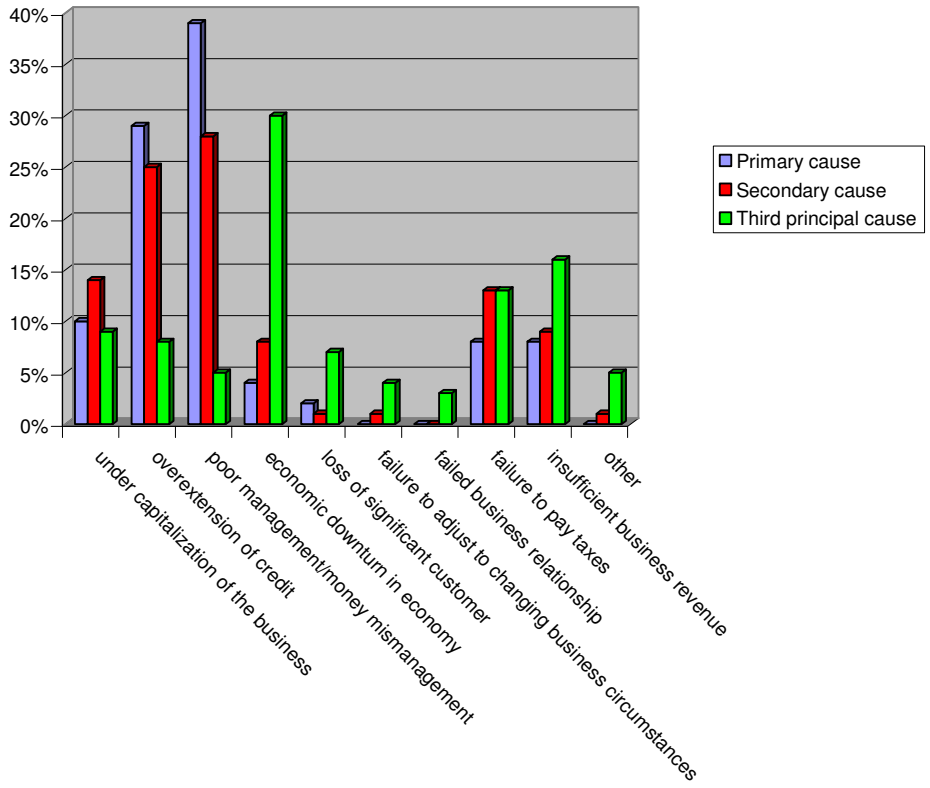
a significant cause of the bankruptcy. 62% reported overextension of credit as a significant cause. One trustee observed that the failure of the commercial banks to make credit available to SMEs, particularly in the Maritimes, has driven entrepreneurs to fund their business with credit cards, suggesting that banks have some responsibility in respect of their participation in lending to SMEs.

42% of the trustees surveyed believe a principal cause of insolvency for sole proprietorships is economic downturn in economy. 34% of trustees reported that failure to pay taxes was a principal reason, whereas 33% declared insufficient business revenue as one of the top three causes of insolvency. 10% reported loss of significant customer as one of the top three causes; 5% reported failure to adjust to changing business circumstances; and 3% reported failed business relationship.

The “other” category included reasons such as greed and unrealistic expectations, offering a more human dimension to causes than stated in forms filed with the OSB.

Graph 9

Principal causes of sole proprietor insolvency, 50 trustee survey



For partnerships, the figures tracked those of sole proprietorship to some extent, suggesting that the same kinds of challenges face partnerships as business operating by single individuals. Fewer trustees answered the survey questions expressly about partnership, with only 37 trustees of the 50 surveyed distinguishing this form of business. The breakdown of their responses is illustrated in Graph 10 below.

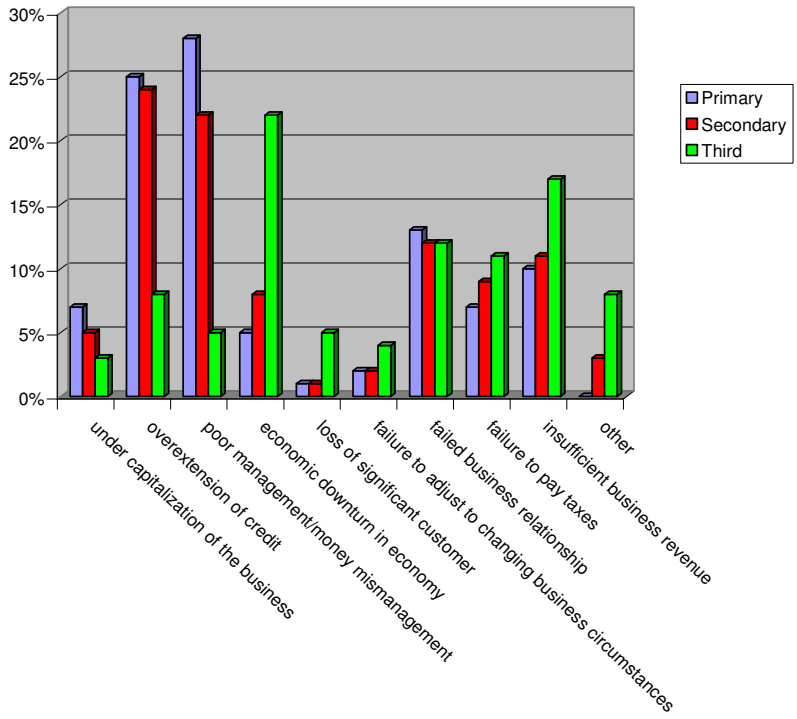
Poor management or money mismanagement is a very significant cause of financial distress in that 55% of trustees surveyed observed that this factor played a significant role in the insolvency of partnerships in their experience, with 28% reporting that it is the primary cause. This figure may suggest that partnerships do not necessarily enhance governance of the business. 15% reported that under-capitalization of the partnership business was a significant cause of the bankruptcy, with 7% reporting that it is the primary cause. This figure is considerably less than for sole proprietorship, indicating that while still a significant problem, partners may be more likely to assess capital needs and require each to commit to a measure of capital investment or capital raising at the commencement of the partnership arrangement.

57% of trustees reported overextension of credit as a principal cause of partnership insolvency, with one quarter of trustees finding it is the primary cause. This response may indicate that once the partnership business

commences, over-leveraging becomes a significant problem. Significant for partnerships was insolvency due to a failed business relationship. 37% of trustees reported that it was a principal cause, with 13% finding the failed business relationship to be a primary cause. 35% of trustees believe a principal cause is economic downturn in economy, although only 5% listed this factor as a primary cause. 27% of trustees reported that failure to pay taxes was a principal reason, although only 7% believe it is the primary cause. 38% observed that insufficient business revenue is one of the top three causes of insolvency. 7% reported loss of significant customer as one of the principal causes; 8% reported failure to adjust to changing business circumstances; and 3% reported failed business relationship.

Graph 10

Principal causes of partnership insolvency, 37 trustee survey responses



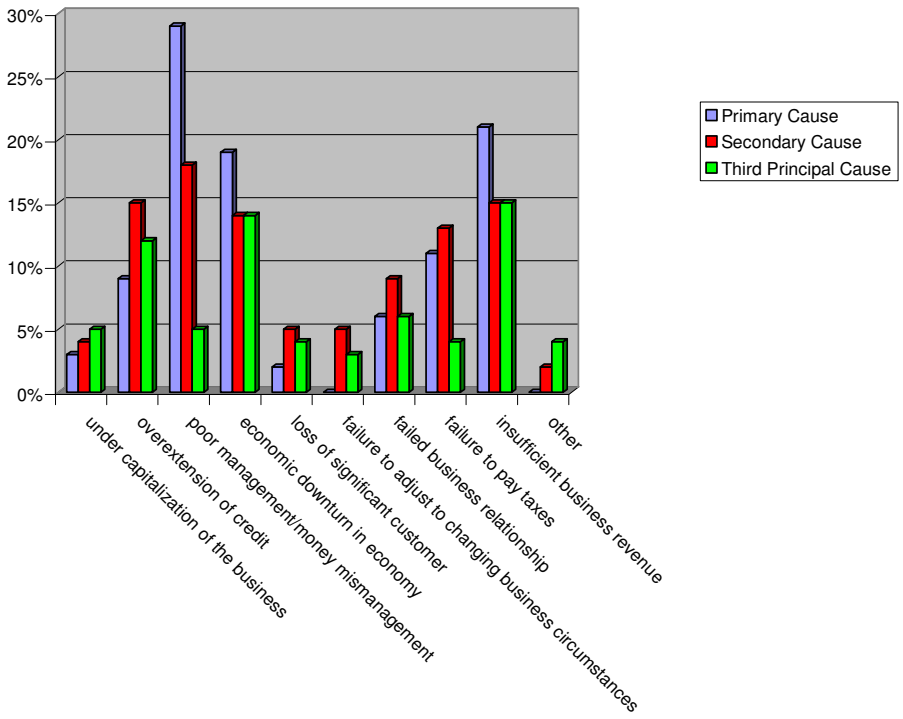
For incorporated businesses, Graph 11 below summarizes the trustee responses. The trustees believe that poor management or money mismanagement is a very significant cause of financial distress, in that 52% of trustees surveyed observed that this factor was a significant cause of insolvency, and 29% reporting it as the primary cause. 51% of trustees reported that insufficient business revenue was a principal cause of business failure, with 21% reporting it as the primary cause for corporate insolvency. 36% reported overextension of credit, although it is only the primary cause for 9% of trustees.

47% believe a principal cause is economic downturn in economy, with 19% reporting that they believe it is the primary cause. 28% of trustees reported that failure to pay taxes was a principal reason. 21% reported a failed business relationship, most often in a partnership in a business that had been

incorporated. 12% reported that under-capitalization of the business was a significant cause of the bankruptcy, with only 3% reported it as the primary cause. 11% of trustees reported that failure to adjust to changing business circumstances was a principal cause.

Graph 11

Principal causes of corporate insolvency, 50 trustee survey



Comparing Graphs 9, 10 and 11, one can see both similarities and differences in the trustee responses regarding causes of insolvency among sole proprietorships, partnerships and corporations. For all business types, the most significant cause overall was poor management or money mismanagement. Under-capitalization of the business appears to be a much more frequently significant factor for sole proprietorships than for partnerships or incorporated businesses, perhaps because the formalities of commencing a partnership or company require more careful analysis of capitalization of the business at the outset.

The trustees also report that downturn in the economy is a principal cause in almost half of corporate insolvencies and more than 40% of sole proprietorships, a factor that does not show up in the data reported to the OSB in anywhere near the same amount. Of the 20 trustees that were resurveyed in March 2009, 100% reported that the economic downturn as a result of the global financial crisis was now a significant cause across all sectors and regions, and a significant driving factor to filing a proposal or making an assignment.

Insufficient business revenue is an important cause across all businesses. While failure to pay taxes is relatively small as the primacy cause of insolvency, where reported as one of the top three, it becomes significant for all businesses.

In summary, the data point to poor management or money mismanagement as a significant source of financial distress. For incorporated businesses, under-capitalization of the business appears less problematic than for sole proprietors. The descriptive reports, both in insolvency files and by trustees, is that sole proprietors can have a good idea for a business, or lose employment and set themselves up in business, without appreciating fully the capital outlay, the challenges of collecting accounts receivable to maintain cash flows, and the ongoing costs of maintaining a business. For incorporated businesses, the financial distress often arises because the business partners or associates that started the business often have skills in the operational aspects, but not in management or business finance. In some cases, the business plan is reported to have been poor or to not have adequately taken into account contingencies; in other cases, there is a lack of any business plan. Larger businesses tend to have fewer governance issues. Finally, in some cases, there is a good business plan in place, but the depth of the financial crisis is far beyond any contingency arrangements in place.

The other aspect of capitalization of the business, over-extension of credit, was a significant cause of insolvency, particularly for sole practitioners. The next part examines the type of debt reported by insolvent businesses in Canada.

VI. SOURCES OF DEBT

Over-extension of credit is a principal contributing factor to insolvency across all types of business, particularly significant among sole proprietorships and partnerships. The over-extension of credit is thus a significant issue for business success in Canada. While debt is generally viewed as an effective means of financing business, the degree of failure attributable to over-extension of credit raises some important questions in respect of the quantum of debt granted and how it is managed.

Debt instruments used by businesses can include bank term or demand loans, private loans, operating lines of credit, credit cards, leases, supplier credit contracts and government-backed loan programs. The two primary means of debt financing are lines of credit and business loans. The OSB reports that 71.2 per cent of businesses hold a line of credit with their financial institution, and 41 per cent have a business loan.[163] Other means of debt financing include commercial and personal mortgages, personal loans, and overdraft protection.[164]

1. Sources of Debt for Business Filings

The study examined the type of debt for insolvency businesses. For the global data, Table 7 below summarizes the type of debt in the 5,515 electronic files studied.

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[163] Citing CFIB (2001).

[164] Equinox Management Consultants Ltd., *Gaps in SME Financing: An Analytical Framework,* Report prepared for Industry Canada, February 2002, http://www.ic.gc.ca/eic/site/sme_fdi-prf_pme.nsf/eng/h_01297.html.

Table 7 Sources of Debt
5,515 business insolvencies, 2006-2008

Type of Debt	Total	Secured Amounts	Unsecured Amounts	Preferred Amounts	Average Amount of Debt per Estate	Median Amount of Debt per Estate
Bank Loans (except real property mortgage)	170,197,380	18,460,655	151,736,725		30,861	6,000
Credit Card	109,169,406	630,734	108,538,672		19,795	7,000
Finance Company Loans	61,017,637	15,538,949.11	45,478,688		11,064	3,203
Loans from Individuals	26,228,614	958,158	25,270,456		4,756	8,000
Other	323,060,771	21,033,840	300,984,217	1,042,715	58,579	580
Real Property Mortgage	220,984,184	188,073,367	32,910,817		40,070	54,000
Student Loans	2,173,372		2,173,372		394	3,783
Taxes Federal/Provincial/ Municipal	228,744,235	4,496,207	223,789,196	458,831	41,477	3,520
Total	**$1,141,575,600**	**$ 249,191,910**	**$ 890,882,144**	**$ 1,501,546**		

Overall, of the 5,515 business insolvencies, there was an average debt of 30,861 CAD from bank loans, and a median of 6,000 CAD. 89% of these loans, usually operating loans, were unsecured.[165] Finance company loans were also a significant source of debt for businesses, although not as significant as credit card debt. The average amount of finance company loan was 11,064 CAD, with a median of 3,203 CAD. 74.5% of this debt was unsecured, with the security most often over specific inventory or equipment.

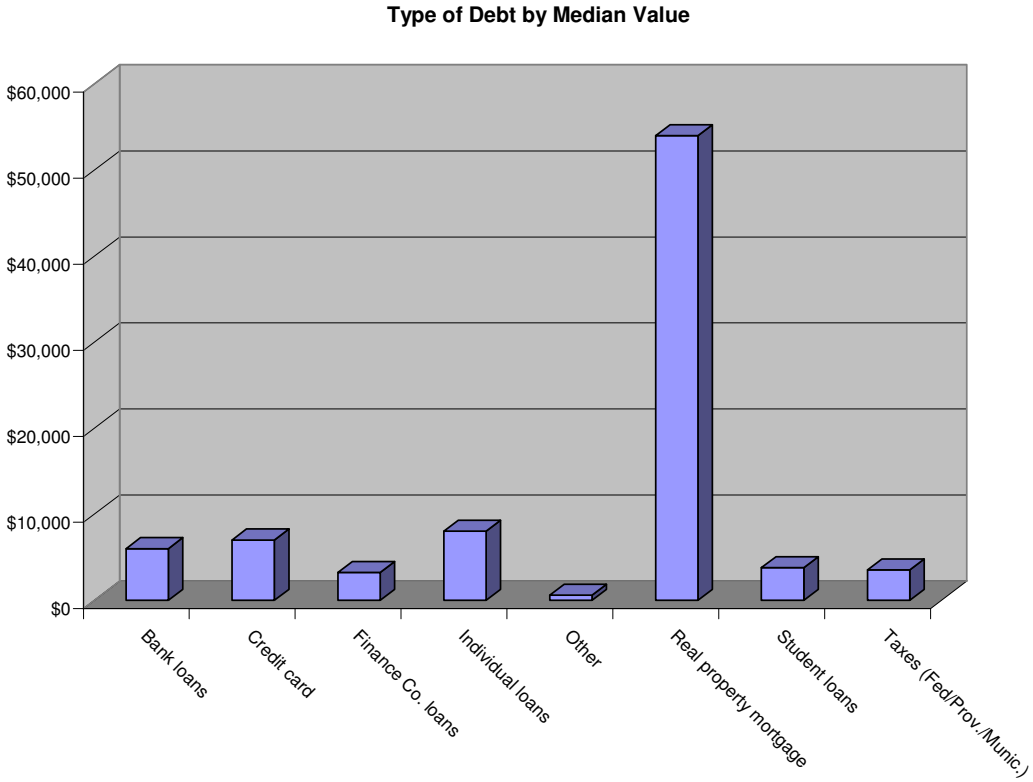
There is an average of credit card debt of 19,795 CAD, and the median amount of credit card debt was 7,000 CAD. 99.4% of this debt was unsecured. The figures suggest that businesses incurred considerable credit card debt in the period leading up to insolvency filing. The descriptive comments on the filings suggested that it was being used to cover expenses when revenues declined and the value of receivables outstanding increased.

Loans from individuals comprised a significant source of debt, primarily for sole proprietors. The average amount was 4,756 CAD, with the median at 8,000 CAD. This type of debt was overwhelmingly unsecured. Real property mortgages were significant, and were by far the largest secured debt, the average amount of real property mortgage debt was 40,070 CAD and the median 54,000 CAD. 85% of real property mortgages for insolvent businesses were secured.

Taxes owing comprise a significant source of debt, with an average of 41,477 CAD. However, the median amount was only 3,520, suggesting that there were a smaller number of business debtors that owe a significant amount of taxes. Graph 12 illustrates the median amount of debt for all insolvent businesses in the 5,515 data set.

[165] The current method that the OSB uses to collect data is to split each debtors' assets and debts into individual constituents of the overall total. For example, instead of reporting each debtors' total debt as one entry, the OSB reports the value of each component such as the value of a bank loan, mortgage, taxes, and so forth. Therefore, to obtain the median value of all the debtors' liabilities, one would need to manually sum each debtor's individual values into one aggregate amount. However, this process of summation becomes difficult to perform manually over the thousands of entries contained in the Excel file. A further complication arises due to multiple entries within the same debt category belonging to the same debtor, such as the individual with 4 different bank loans, which would require further manual oversight. Therefore, to facilitate the process of calculating median values for total debts or total assets for all the debtors, the OSB could record these total values in addition to the sections pertaining to the breakdown so that researchers are given the choice between investigating median values per category and median values for total assets and debt. To facilitate data analysis for total figures, the OSB could record the total assets and the total debts so that the summation process is completed beforehand and so subsequent calculations can be completed quickly through Excel's automated processes. My thanks to Bernard Lau, UBC Law II, for making this observation.

Graph 12

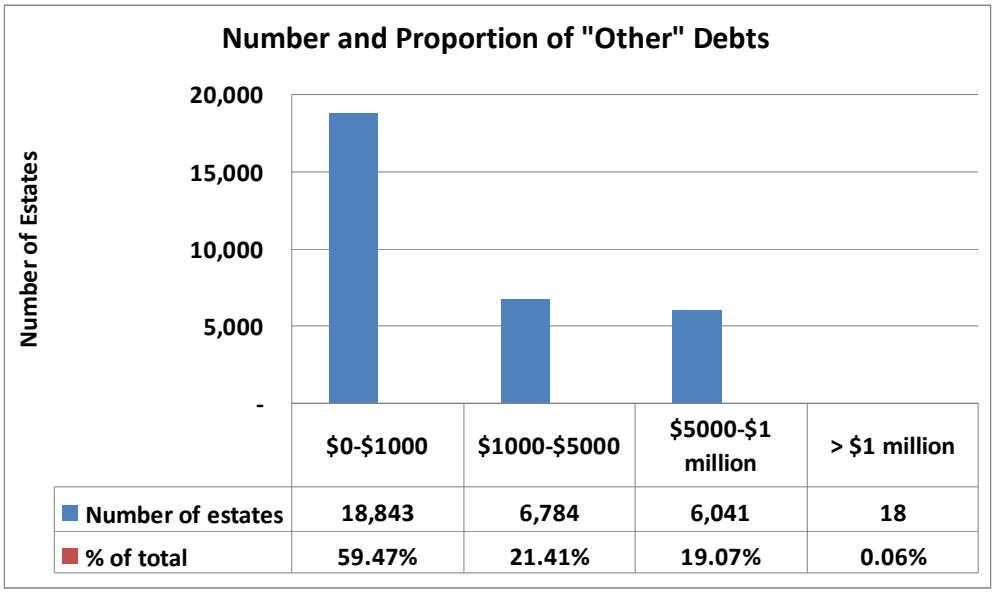


Unfortunately, the study was unable to break down the data in the large cohort into types of businesses, which would have provided a more informative picture of where different types of debt are significant for different types of business arrangements. We were able to calculate the median debt by type of business for 200 representative files, as discussed below.

"Other" sources of debt set out in Table 7 above was significant. The median amount was only 580 CAD, whereas the average was 58,579 CAD, because of a small number of very high debts, skewing the average numbers. It is difficult to place an accurate descriptor on what is included in the "other' category. The study found a high proportion of low-value debts in this category, with almost 60% of the total below $1000, which accounts for the low median value. However, only 0.06% of debts were valued at more than one million CAD. Graph 13 below illustrates this pattern, which explains why the median is much lower than the average. The majority of entries of debt of low value were small expenses incurred in the day-to-day operations of either the business or the individual that did not fit into any of the other categories.[166]

[166] There were no details on how the 1 million plus CAD debts in the "other" category were incurred that did not fit under the categories like mortgages or loans.

Graph 13
"Other" debts by number and value



As Graph 13 indicates, there were 18 files with "other debts" greater than 1 million CAD, of which eleven were personal guarantees for corporate debt, ranging from 1 million to 2.5 million CAD, with two outliers at 18 million CAD and 7 million CAD respectively, both also debt arising from personal guarantee of corporate debts. One debt at 1 million CAD was gambling debt, and two related to spousal business failure and personal guarantees. The figures suggest that while some education has been done to warn business people of the risk of giving personal guarantees for large amounts of debt, it is still a significant problem in some instances. In a number of cases, the only means of financing a small or start-up business is through personal guarantees.

2. Trustee Observations on Sources of Debts

In terms of sources of the debt, the trustee survey revealed some interesting insights that are not fully picked up in the electronic data. In particular, trustees were asked about the financing of small and medium enterprises.

58% of the 50 trustees surveyed reported that personal credit cards are now being used to finance businesses, especially in the case of small businesses that are sole proprietorships or partnerships.[167] 10% report that personal bank loans are increasingly being used to finance businesses and 6% observe a recent rise in using home equity as a line of credit for the business.

16% of trustees surveyed observed that traditional credit sources are still being used. However, 4% of trustees point to high interest loans being used as a means

[167] The question asked was: In your experience, are small businesses or small proprietorships using sources of credit outside of conventional forms of credit such as bank loans or credit card debt?

of financing operations. One trustee observed that the use of personal assets to guarantee business debt has declined slightly in its practice, crediting new public advertising campaigns that discuss the risks of investing the debtor's own money in his or her business. 15% of trustees wrote that, in their experience, borrowing money from friends and relatives is on the rise.

19% of trustees pointed to the government as a source of new credit. The observation is the business people use Revenue Canada as a lender by paying their taxes late. Delayed GST and tax payments are being used increasingly as a means to bridge short term cash flow problems.

14% reported that delayed payments to suppliers and creditors are a growing form of credit, in that debtors delay paying accounts payable as a means of bridging cash flow problems. 6% of trustees observed that factoring companies are now being used, and thus their taking over accounts receivable makes them a new type of creditor. 8% of trustees reported that specialized lenders, i.e. equipment leases, continue to increase in terms of the proportion of debt. 4% observed that people are cashing in Registered Retirement Savings Plans in order to bridge difficult financial periods in the business, although this practice may slow with RRSPs being offered new exemption protection under the proposed amendments to the *BIA.*

The rise in consumer debt in Canada is in part attributable to the growth in the alternative financial services market, the most well known of these services being pay day loans. Yet the trustee survey reveals that this alternative financial services market may also be problematic for financing very small businesses of sole proprietorships. 14% of trustees reported that pay-day loans are being used by sole-proprietors.

While there has not yet been a study of the effects of these alternative financial services for businesses, Professors Ruth Berry and Karen Duncan report that more than 350,000 Canadians use pay day loans each year, and that while costs of a first pay day loan may be 20% interest over two weeks, typically the loans are repeatedly rolled over with increased fees and service charges.[168] Another study indicates that on average, pay day lenders provide 15 rollover loans for every first time pay day loan extended.[169] Berry and Duncan found that in 2006, 25% of insolvent consumer debtors owed more than 25% of their monthly income to payday lenders.[170] However, they found that the incidence of filing proposals and bankruptcies was almost identical, suggesting that the data do not point to consumers filing for bankruptcy over a proposal based on the number of pay day loans held.[171]

It would be helpful to have this research extended to small businesses in terms of gaining a clearer understanding of how alternative financial services may be having an impact on small business insolvency.

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[168] Ruth Berry and Karen Duncan, "The Importance of Pay Day Loans in Canadian Consumer Insolvency, 2008 (on file with the Office of the Superintendent of Bankruptcy).

[169] Ernst & Young, "The Cost of Providing Payday Loans in Canada" (2006) http://www.cpla-acps.ca/english/reports/EYPaydayLoanReport.pdf.

[170] *Ibid.* at 11. The amount of pay day debt is still not transparent, as it gets recorded across different categories of debt. Of note is that Berry and Duncan found that in 2006, 32% of insolvent pay day loan holders had previously filed bankruptcy or proposal proceedings, compared with 15% of those not holding pay day loans, at 13.

[171] *Ibid.*

3. Type of Assets

Table 8 sets out the type of assets held by business debtors, as available in the OSB database, including the amount secured against the asset, the estimated realizable and the median value of assets. Unfortunately, the study has not been able to get these data broken down by type of business. For the entire data set of 5,515, it is clear that houses continue to be the most significant asset.

Table 8
Assets of Business Debtors, 5,515 files, 2006-2008

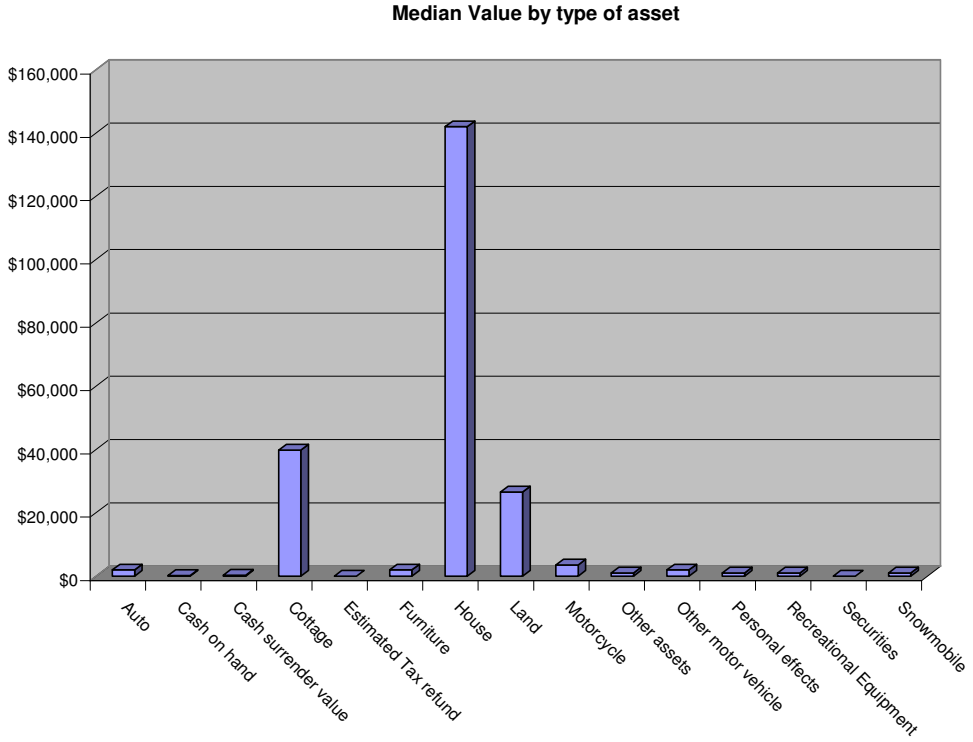
Assets of Debtors

Type of Asset	Total	Secured Amounts	Estimated Realizable	Median
Automobile	23,231,435.45	17,545,945.25	766,343.98	2,000
Cash on hand	1,075,118.29	80,000.00	840,539.08	200
Cash surrender Value	17,882,963.47	530,388.90	1,679,600.29	300
Cottage	1,024,900.00	941,741.00	47,200.00	39,000
Estimated tax refund	20,298.79	5,000.00	11,460.63	1
Furniture	9,644,479.95	91,620.42	6,430.00	2,000
House	227,358,076.99	203,690,445.54	5,078,654.12	142,000
Land	12,807,123.00	10,215,645.15	680,398.75	26,625
Other assets	23,771,457.70	11,807,417.41	1,909,761.05	1,000
Other motor vehicle	2,487,405.25	1,903,461.25	275,426.00	3,000
Personal effects	3,633,433.50	2,775.00	49,550.50	1,000
Recreational equipment	1,406,501.00	1,125,507.00	217,086.00	1,000
Securities	2,217,631.61	484,375.07	382,135.53	1
Snowmobile	238,196.00	145,984.49	53,590.00	1,000
Total	**326,799,021**	**248,570,306**	**11,998,176**	

The medians in Table 8 plotted on a graph provide a more graphic illustration of the extent to which house, land and cottage continue to remain the most significant assets of debtors engaged in business that file proceedings under the *BIA.* For those business debtors that are not shielded by the limited liability of corporate status, when the business becomes financially distressed, personal assets that are unencumbered and not exempted are utilized to satisfy the business debts.

Even for incorporated small businesses, the personal assets of principals are often at risk in the insolvency. There are likely few SMEs where the principals were able to finance an incorporated business without personal guarantees. Thus, their personal assets are generally as much on the line as the sole proprietor. Numerous individual bankruptcies that are filed are as a result of the demand made on such personally guaranteed traditional business financing vehicles.

Graph 14



4. Assets and Liabilities by Type of Business and Proceeding

The OSB's global reporting of data does not distinguish partnerships from other types of businesses. To gather a more accurate picture in this respect, the study analysed 200 representative business bankruptcy files from 2007 and 2008 in terms of debts and assets for sole proprietorships, partnerships and corporations. The data indicate that median asset value for bankruptcies is lower than that for proposals. This difference is to be expected, since a significant reason for undertaking a proposal is to preserve the value of the assets for the insolvent business.

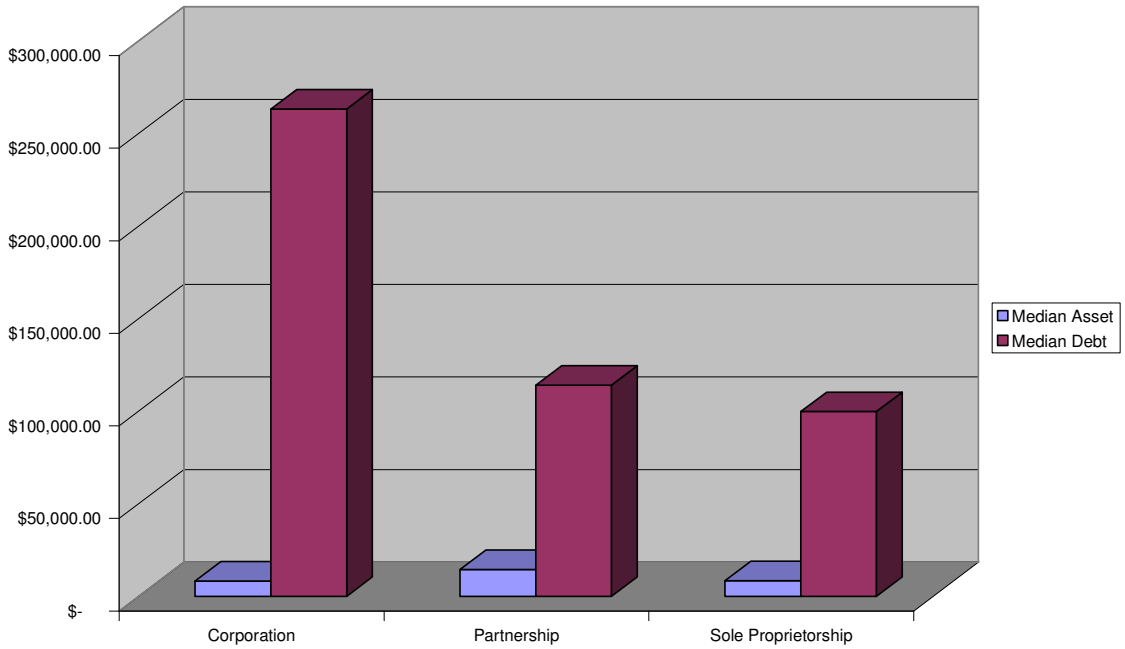
The study found that the median asset amount held by corporations was 8,322 CAD, compared with 14,552 CAD for partnerships and 8,500 CAD for sole proprietorships. In contrast, corporations have a much higher median debt than partnership or sole proprietorship. The median debt for corporations filing for bankruptcy was 263,127 CAD. For partnerships, the median amount of debt was

114,028 and for sole proprietorships, the median amount was 99,799 CAD. Graph 15 below summarizes that data. Interestingly, the amount of median debt for both partnership and sole proprietorship is significant in terms of the personal risks faced in these forms of business.

The debt to asset ratio is much higher for corporations than for partnerships or sole proprietorships for corporations filing bankruptcy proceedings. Corporations in this cohort had fewer assets available to meet creditors' claims than other types of businesses, as illustrated by Graph 15.

Graph 15

Median asset and debt, business bankruptcies

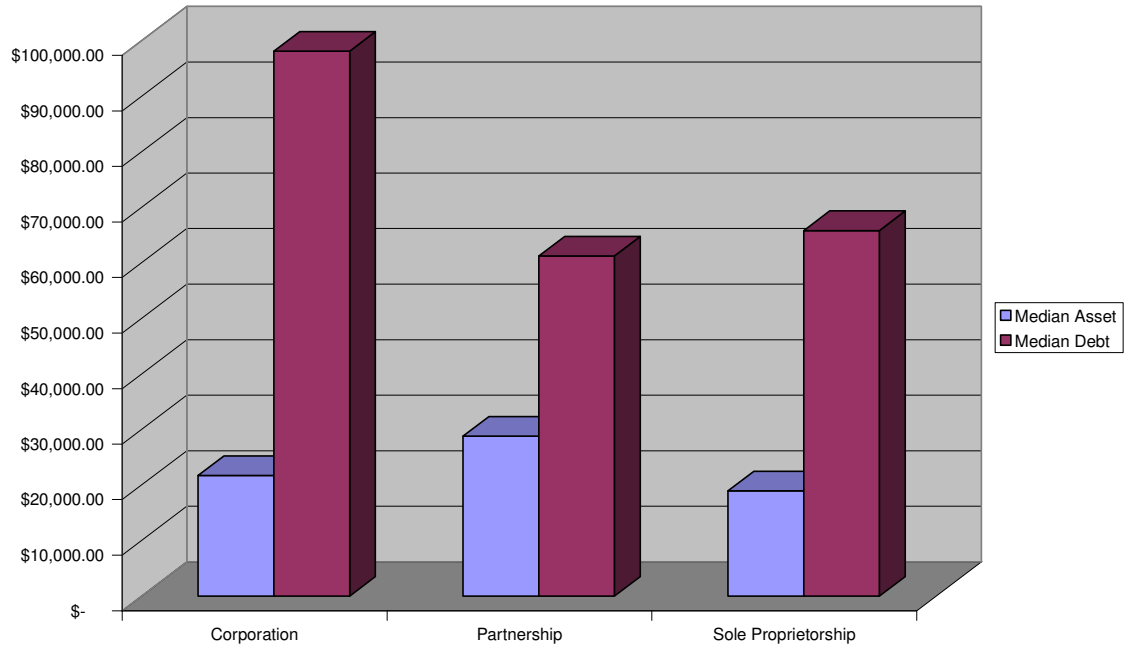


For business proposals, a study of 200 representative business proposals indicates a slightly healthier asset to debt ratio under all three categories of business. Corporations filing proposals have considerably higher median debt than partnerships or sole proprietorships, and yet not significantly greater assets.

For corporations filing proposals, the median debt was 98,115 CAD, compared with 61,218 CAD for partnerships and 65,800 for sole proprietorships. Note that the median amount is far below the 5 million CAD that would be required for access to the *CCAA*. For corporations filing proposals, the median value of assets was 21,701 CAD, compared with 28,800 CAD for partnerships and 18,950 for sole proprietorships. This data is illustrated in Graph 16 below.

Graph 16

Median assets and debts, business proposals



Thus, for this cohort of 200 files, the median asset value for corporations filing proposals was double the asset value for corporations filing bankruptcy; for partnerships the median assets were also double those of partnerships in bankruptcy; and for sole proprietorships, the assets were 2.5 times the value of assets for sole proprietors filing bankruptcy proceedings. Where there is a healthier debt to asset ratio, business debtors are more likely to attempt to develop a proposal for creditors to consider.

Debt to asset ratio can serve as a signalling device for SMEs in terms of their overall financial health and risk in the period prior to insolvency; and as an indicator of what options may be the best to pursue once the business is insolvent.

ii. Division II Business Proposals, Assets and Debts

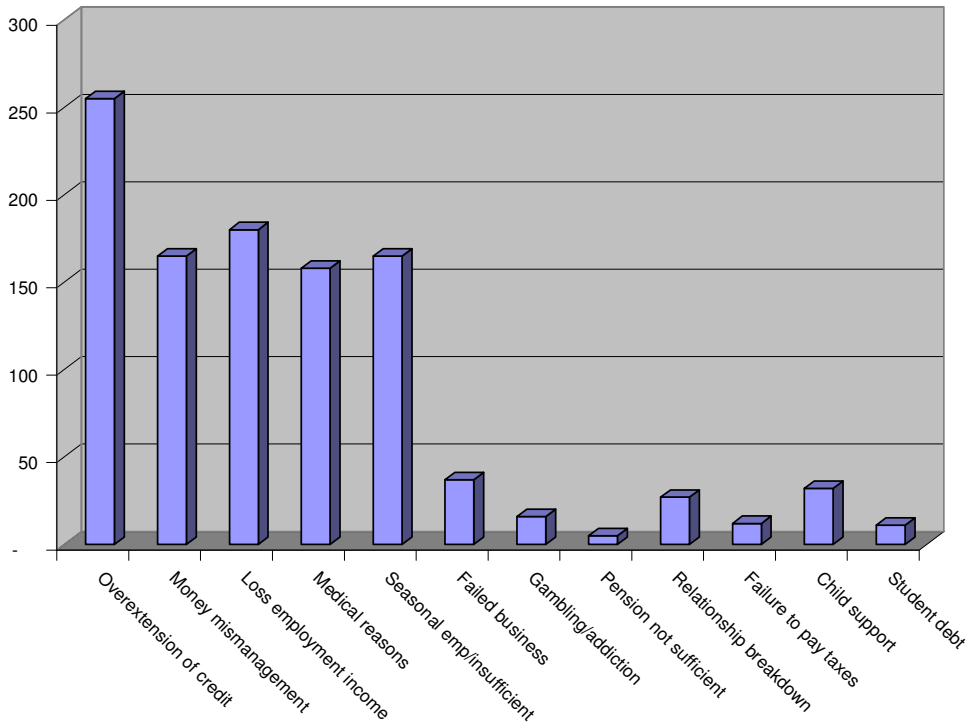
An earlier study by the author examined a data subset of 1,063 Division II business proposals from 2005 to 2007.[172] Graph 17 below summarizes the causes of financial distress for Division II business proposals.[173] This cohort was comprised primarily of individuals that were sole proprietors or in a small partnership. 24% of the Division II business proposal debtors declared overextension of credit as the

[172] Janis Sarra, *Economic Rehabilitation: Understanding the Growth in Consumer Proposals,* May 30, 2008, Study for the Office of the Superintendent of Bankruptcy.
[173] *Ibid.* They are classified as "business proposals" by the OSB because 50% or more of their debt is business-related.

primary cause of their insolvency, while 15.5% reported that it was money mismanagement. For 17%, the primary cause was loss of employment income and for 15.5%, the cause was seasonal employment or insufficient income. Interestingly, because these proposals are business related, only 3.5% report a failed business as a cause of the insolvency, likely because the point of the proposal may be to salvage the business activity where possible and because these individuals are dealing with both personal debt and business debt in one proceeding.

Graph 17

Causes of Insolvency for Debtors Filing Division II Business Proposals



The data indicate that in a number of cases, other financial pressures placed the individual into financial distress and the business proposal provided the mechanism to try to preserve the business. 15% reported medical reasons as the primary cause of their insolvency. One explanation for this figure is that the individual in many cases would not have access to supplemental health benefits and income replacement that is often available in an employment relationship with companies.[174] However, it is difficult to discern from the data in any statistically significant manner if the rates refer to medical bills over and above coverage by the national healthcare system, or if some portion is due to lost income arising from medical problems. These causes appear somewhat conflated in the reported descriptions field, and deserve further study. Only 1.1% cited the cause as failure to pay taxes. Relationship breakdown, student debts, child support and level of pension were not significant reported causes of the insolvency.

[174] Sarra, *supra,* note 151.

Turning to the types of liabilities these individuals had at the time of filing, Table 9 sets out the sources of debt for the cohort of 1,063 debtors that filed Division II business proposals. Here, mortgages played a significant role in the insolvency and may be a driver for filing a proposal rather than bankruptcy. 60.8% of total liabilities for this cohort were mortgage debt. The mean and median amounts were 144,890 CAD and 137,000 CAD respectively.

14.6% of total liabilities are for credit card debt, of which 98% was unsecured. 12.3% of total liabilities are for bank loans, excluding mortgages on real property. The mean and median are 22,263 CAD and 18,192 CAD respectively, suggesting that credit card liability is significant for Division II business debtors, even for debtors with less than 75,000 CAD in debt.[175]

Table 9 also highlights that 5.7% of total liabilities, a median of 10,000 CAD, are for finance company loans, most of which were unsecured. Trustees have reported that there are often consolidating loans whereby debtors get credit card debt consolidated, and that this effort to control debt is frequently undertaken before any insolvency filing.

The amount of tax owed was only 1.3% of total liabilities by dollar amount, suggesting that the tax relief was not a reason that proposals were being filed. However, 40% of all those filing had taxes owing, with the median at 1,964 CAD. This figure suggests that while tax debt was not a primary cause of insolvency for this group, a significant number of individuals may let their taxes slide in the period prior to becoming financially distressed.

Table 9

Source of Debt Division II Business Proposals,

1,063 files

Type of Debt	Total (Preferred, Unsecured and Secured)	Secured Amounts	Unsecured Amounts	Preferred Amounts	Number of Estates (Preferred, Unsecured and Secured)	Mean Amount of Debt per Debtor	Median Amount of Debt per Debtor
Bank Loans (except real property mortgage)	17,342,925	3,178,779	14,164,146	-	779	22,263	18,192
Credit Cards Bank/Trust Companies Issuers	12,779,590	33,250	12,746,340	-	907	14,090	9,911
Credit Cards Other Issuers	7,747,140	12,013	7,735,127	-	844	9,179	5,843
Finance Company Loans	8,004,626	2,835,589	5,169,037	-	605	13,231	10,000
Loans from Individuals	181,552	57,000	124,552	-	23	7,894	5,000
Other	6,381,596	701,235	5,677,061	3,300	707	9,026	4,339
Real Property				-	592		

[175] For a discussion of this issue, see Janis Sarra, *Economic Rehabilitation: Understanding the Growth in Consumer Proposals,* May 30, 2008.

Mortgage	85,775,072	84,972,365	802,707			144,890	137,000
Student Loans	935,623	-	928,623	7,000	90	10,396	7,367
Taxes Federal/Provincial/ Municipal	1,868,519	93,695	1,759,824	15,000	422	4,428	1,964
Total	141,016,643	91,883,925	49,107,417	25,300			

Professor Iain Ramsay has noted that in the U.S., there is substantial overlap of consumer and business debt, with many business debtors reporting a combination of business and personal reasons as triggers for their bankruptcy filings.[176] This comingling of debt may help to explain the number of "business proposals" under the Division II consumer debtor proposal provisions under the Canadian *BIA*.

Table 10 sets out the summary data on the assets of debtors filing Division II business proposals. The median amount of house value was 150,000 CAD and compared with mortgage liabilities for this cohort, there was a median amount of equity of close to 15,000 CAD. There are significant assets in motor vehicles of different kinds, cottages and land, the vast majority of which are non-exempt assets.

Table 10

Assets for Debtors Filing Division II Business Proposals,

1063 files

Type of Asset	Total (Exempt and Non-Exempt)	Exempt Amounts	Non-Exempt Amounts	Estimated Realizable	Number of Estates (Exempt and Non-Exempt)	Mean (Exempt and Non-Exempt)	Median (Exempt and Non-Exempt)
Automobile	7,442,293	2,249,066	5,193,227	281,246	896	8,306	5,750
Cash on hand	190,998	18,389	172,609	153,721	137	1,394	250
Cash surrender value	5,360,655	4,279,992	1,080,663	361,250	331	16,195	5,532
Cottage	129,900	-	129,900	76,800	7	18,557	16,000
Estimated tax refund	1	-	1	1	1	1	1
Furniture	3,307,865	3,245,504	62,361	9,745	869	3,807	3,000
House	94,030,201	12,680,658	81,349,543	2,318,804	604	155,679	150,000
Land	225,046	-	225,046	79,117	15	15,003	8,946
Motorcycle	81,899	32,550	49,349	9,351	26	3,150	2,000

[176] Iain Ramsay, "Comparative Consumer Bankruptcy" . University of Illinois Law Review, p. 241, 2007 Available at SSRN: http://ssrn.com/abstract=958190. Iain Ramsay conducted a five-year empirical study of about 3,200 business cases originally filed in Chapter 7, Chapter 11 and Chapter 13 in 23 judicial districts during 1994, including both small and large businesses.

Other assets	1,632,370	730,052	902,319	159,909	162	10,076	2,000
Other motor vehicle	361,766	34,500	327,266	66,495	54	6,699	4,000
Personal effects	1,146,020	1,128,490	17,530	7,500	590	1,942	1,000
Recreational equipment	226,976	17,200	209,776	64,407	45	5,044	2,500
Securities	1,796,801	1,545,574	251,227	92,831	137	13,115	3,200
Snowmobile	45,051	6,500	38,551	12,400	24	1,877	1,250
National	115,977,843	25,968,474	90,009,368	3,693,578			

The cohort of Division II business files provides yet another snapshot of type of debts and potential reasons for insolvency. A significant number of proposals are not successful, and Part VII below examines data on failed business proposals.

VII. SUCCESS AND FAILURE OF BUSINESS PROPOSALS

The OSB also reports the number of successful and failed business proposals over time. Its data to the end of 2007 are summarized in Table 11 below. Given the period over which proposals operate, the more recent files are not particularly helpful in discerning when and why proposals are successful or fail, as a significant number of proposals are still ongoing. For the earlier years, 2002 to 2004, one can see that a significant number of proposals are successfully completed, however, a comparable number also fail. For a definition of when and why the proposals failed, see Table 12 and the discussion accompanying it.

Table 11

Failed Business Proposals by year filed, Office of the Superintendent of Bankruptcy, 2008

Year Filed				Total
	Failed	Ongoing	Successfully Completed	
2002	963	83	879	1925
2003	887	142	814	1843
2004	807	233	684	1724
2005	789	401	466	1656
2006	601	514	316	1431
2007	548	630	133	1311
Total	4595	2003	3292	9890

Table 11 indicates that 50% of all business proposals in 2002 were successfully completed. 46% failed and 4% are ongoing. In 2003, 44% of all business proposals were successfully completed; 48% failed and 8% are ongoing. A greater number of proposals are still ongoing in subsequent years. However, for those 2004 proposals that are not ongoing files in 2008, the success rate was 46% and failure 54%.

The current study examined the pressure points in terms of failure of business proposals at various stages of the process, including: failure to file cash flow statements within ten days; failure to file a proposal within the initial stay or extended stay period after a notice of intention is filed; failure due to the proposal not being accepted by creditors; decisions by the court not to accept the proposal; and failed successful completion of the proposal. Table 12 summarizes the data available from the OSB.

Table 12
Failures by Type of Proceeding,
Office of the Superintendent of Bankruptcy, 2008

Type of filing	2002	2003	2004	2005	2006	2007	Total (and %)
Bankruptcy Order, Previous Failure of Division I Proposal	1	1	1	2	0	5	10 (0.2%)
Voluntary Assignment Following Division 1 Proposal	144	137	129	113	100	92	715 (15.6%)
Withdrawn Division II Proposal Before Approval	7	9	7	15	11	8	57 (1.2%)
Creditors refused to accept Div II proposal	35	38	31	40	32	37	213 (4.6%)
Division I Proposal in default	165	131	131	117	90	41	675 (14.7%)
Failure to file cash flow statement (deemed bankruptcy s. 50.4(8)(a)	33	32	36	19	21	25	166 (3.6%)
Failure to file Division I proposal	154	151	110	123	114	112	764 (16.6%)
Creditor Vote Against Division I Proposal	217	209	208	229	147	185	1195 (26.0%)
Creditors Acceptance Refused Reinstated Bankruptcy Order – Division I Proposal	0	2	0	1	0	1	4 (0.09%)
Creditor Acceptance Refused Reinstated Assignment, Division I Proposal	0	1	0	1	4	0	6 (0.1%)
Court Approval Refused Division I Proposal	22	9	9	12	7	8	67 (1.5%)
Court Approval Refused Reinstated Assignment after Division I Proposal	1	1	1	0	0	0	3 (0.06%)

Bankruptcy Order – Division I Proposal Annulled	50	43	30	22	11	4	160 (3.5%)
Reinstated Bankruptcy – Division II Proposal Withdrawn or Creditors Acceptance Refused	0	1	0	1	0	0	2 (0.04%)
Deemed Annulment – Division II Proposal by a Debtor – In Default	132	121	108	90	62	30	543 (11.8%)
Court Annulment – Division II Proposal by a Debtor	2	0	3	4	1	0	10 (0.2%)
Deemed Annulment – Div II Proposal by a Bankrupt (no bankruptcy)	0	1	3	0	1	0	5 (0.1%)
Total	963	887	807	789	601	548	4595 (100%)

Table 12 indicates that from 2002 to 2007, there were 4,595 failed proposals. Of these, 166 or 3.6% failed almost immediately after filing for failure to file a cash flow statement, resulting in deemed bankruptcy. 764 business debtors or 16.6% failed to file the Division I proposal.

Hence, one fifth of all business proposal proceedings fail at the outset, before a proposal is actually filed. One explanation is that the notice of intention is filed to give the debtor breathing space while it decides how to deal with the insolvency, which would support one of the study's working hypotheses that the actual success rate of proposals is higher if one excludes those debtors that did not necessarily intend to make a proposal. However, another explanation is that business debtors attempted to negotiate with creditors and withdrew from the proposal proceeding when it became apparent that the debtor was not going to be able to garner the requisite level of creditor support. The reasons need further investigation.

The most significant point of failure is creditor refusal to support the proposal. For all business proposals, 30.8% fail due to lack of creditor approval. For Division I business proposals, 1,205 or 26.2% of the proposals failed to garner the requisite level of support by creditors.[177] For Division II business debtors, only 213 or 4.6% of Division II proposals failed due to lack of requisite creditor support. These numbers include business professionals seeking to reorganize their debts.

The difference between the two Divisions in terms of creditor opposition to proposals may be a function of the amount of debt involved, less than 75,000 CAD. However, it may also be a function of the structure of creditor approval under Division II. Given the default structure for creditor objection under Division II, creditors are less likely to oppose a proposal as it requires affirmative action on their part. Given that the debt level will be raised under the *BIA* amendments to 250,000 CAD, affording more individual business debtors the opportunity to make a proposal under Division II, this amendment may reduce the number of failed proposals.

[177] This figure includes 4 reinstated bankruptcy order where creditors refused to accept a Division I proposal and 6 Reinstated Assignment, Division I Proposal Creditor Acceptance Refused.

715 or 15.6% business debtors made a voluntary assignment following proposing a Division I proposal. Here again, withdrawal and voluntary assignment may have been due to an inability to persuade creditors to vote in favour prior to the proposal being formally taken to a vote. It is not clear on the face of the data, but the trustee interviews indicate it is a common scenario.

675 or 14.7% businesses failed in their Division I Proposal through default of the terms of the proposal. 160 or 3.5% involved a bankruptcy order after a Division I proposal was annulled. 10 or 0.2% failed when a bankruptcy order was made following failure of a Division I proposal.

In terms of Division II business proposals, 57 business debtors, only 1.2% withdrew a Division II proposal before court approval was sought.[178] Here again, the filing of a proposal proceeding may serve as a placeholder for debtors, granting them temporary relief from creditors until they determine what they are going to do about their financial distress. However, given the low overall percentage of Division II debtors, it does not appear to be the predominant practice.

543 or 11.8% were Division II business proposals where there was a default and deemed annulment. The high rate of failure at this point is likely due to the arbitrariness of the deemed failure provisions and limited opportunity to salvage a proposal once three months or three payments are missed. This problem is likely to be remedied with the proposed amendments that allow for revival of proposals, as discussed in Part III.

10 or 0.2% of proposals failed where they were Division II proposals that the court annulled. The court rarely refuses to approve a proposal once it has received the requisite creditor support.

1. Trustee Views of Factors Influencing Success or Failure of Proposals

The 50 trustees surveyed were asked what factors contribute to the success or failure of proposals. 27% of trustees reported that in their experience there is a high success rate for business proposals; observing that their commercial proposals rarely fail. One fifth reported that they believe that the reasons for failed or successful business proposals are the same for corporations, partnerships and sole proprietorships.

The biggest success factor for business proposals, according to the surveyed trustees, is good management. 38% of trustees reported that good management, new management or an improved mindset of management can contribute to a successful commercial proposal. 27% trustees pointed to adequate recapitalization and good cash flow as being on the top of the list for potential success or failure; specifically, the ability to fund and restructure, meet projected revenues, and have realistic expectations about the debtor's going forward cash flow.

16% of trustees reported that the way creditors view a debtor's case affects its likelihood of success, including views in respect of the credibility of the debtor, and willingness of creditors to cooperate in a restructuring of the debt terms. If the proposal offers a high enough return to the creditors and better than from bankruptcy and liquidation, creditors are likely to support the proposal.

[178] Pursuant to *BIA,* s. 66.25.

7% of trustees reported that the terms of the proposal are the most important factor in a successful proposal. 6% of trustees observed that professional individuals have a better chance of a successful proposal, although particulars were not given as to why. One explanation may be their higher earning potential, particularly dentists, doctors and other essential services providers. Other factors that trustees thought could affect the success rate are market confidence, timing, meeting financial obligations, availability of suppliers and market conditions.

The failure of proposals, according to 35% of surveyed trustees, is due primarily to poor management. Under-capitalization and unrealistic cash flow projections were also reported as a principal reason that proposals fail, with one third of trustees noting this reason. Trustees stressed the importance of having a good business plan, including realistic cash flow expectations. 3% reported that creditors often manipulate the system to work for them, rejecting a proposal if they can get at personal assets through bankruptcy. The failure of a proposal to fraud or fraudulent conduct was reported by 2% of trustees.

A number of trustees observed that corporations and partnerships have different reasons for successful proposals. 21% trustees wrote that management is the most important factor for incorporated businesses and partnerships. 21% of trustees reported that new funding or new investors is usually needed. The main reasons corporations' proposals fail, according to 18% of surveyed trustees, is the lack of collaboration of secured creditors. One trustee observed that he thought too much unrealistic optimism is to blame.

With respect to sole proprietorships, trustees generally observed that the reasons for success or failure are more varied, often relating to personal circumstances as well as business factors. Just as personal insolvency is caused by a range of family, medical and other crises that can precipitate financial distress, so too can these events influence the success rates of proposals. 5% of trustees observed that cash flow issues are frequently the most important factor. 12% attributed failure to the arbitrary payment period and deemed failed proposals, as they have been inflexible in dealing with a short period of insufficient business revenue or accounts receivable. Creditor acceptance of the proposal can be more difficult for sole proprietors than corporations, and in this respect, several trustees noted that creditor education was likely as important as debtor education.

The trustee views offer a more multifaceted analysis of why proposals succeed or fail, and while management and capital are significant, there are often complex and layered reasons, including both creditor and debtor motivation.

2. Recovery Rates under Proposals versus Bankruptcy

There are no published reports by the OSB on bankruptcy dividends versus proposal payments in terms of recovery to creditors. Data is available, however, on percentage of proven claims paid out in proposals versus dividends in bankruptcy.[179] The study analysed a data set of 4,720 business files provided by the OSB for the period January 2007 to April 1, 2009 that were completed files.

Table 13 sets out the mean and median recoveries to creditors by type of proceeding. While the average recovery in ordinary bankruptcy proceedings is 4.93%, the median is zero, meaning that there are a number of bankruptcy cases

[179] Dividends minus levy.

in which creditors see little or no recovery. Similarly, in summary administration bankruptcies, the average recovery is 2.17%, but the median is zero.

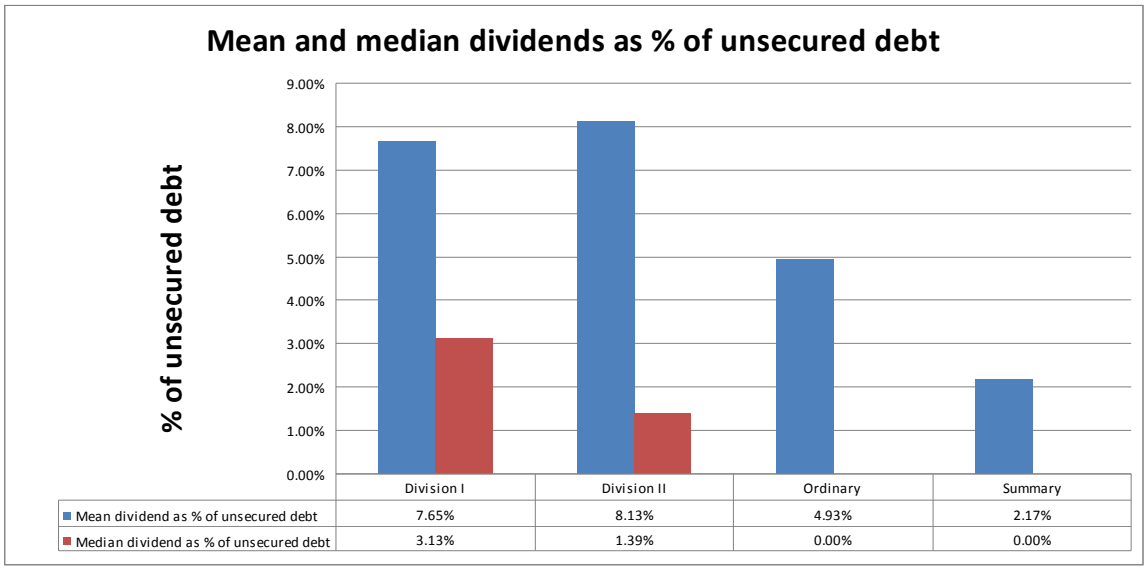
The data indicate that recoveries are considerably more on proposals, but not as high as one might have expected. For Division I, the recovery rate is an average of 7.65%, but the median only 3.13%. For Division II files, the recovery rate is an average of 8.13%, but the median much lower at 1.39%.

Table 13
Recovery to Creditors by Type of Insolvency Proceeding,
January 1, 2007 to April 1, 2009

	Mean dividend as % of unsecured debt	Median dividend as % of unsecured debt
Division I	**7.65%**	**3.13%**
Division II	**8.13%**	**1.39%**
Ordinary	**4.93%**	**0.00%**
Summary	**2.17%**	**0.00%**

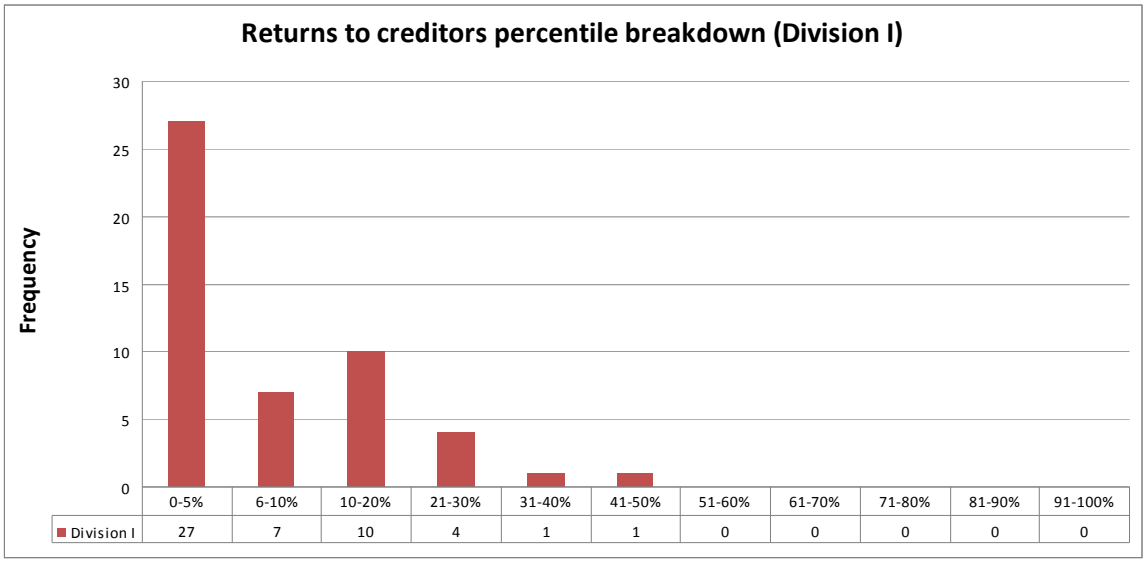
The same figures are represented in graph form in Graph 18 below.

Graph 18
Recovery to Creditors by Type of Insolvency Proceeding



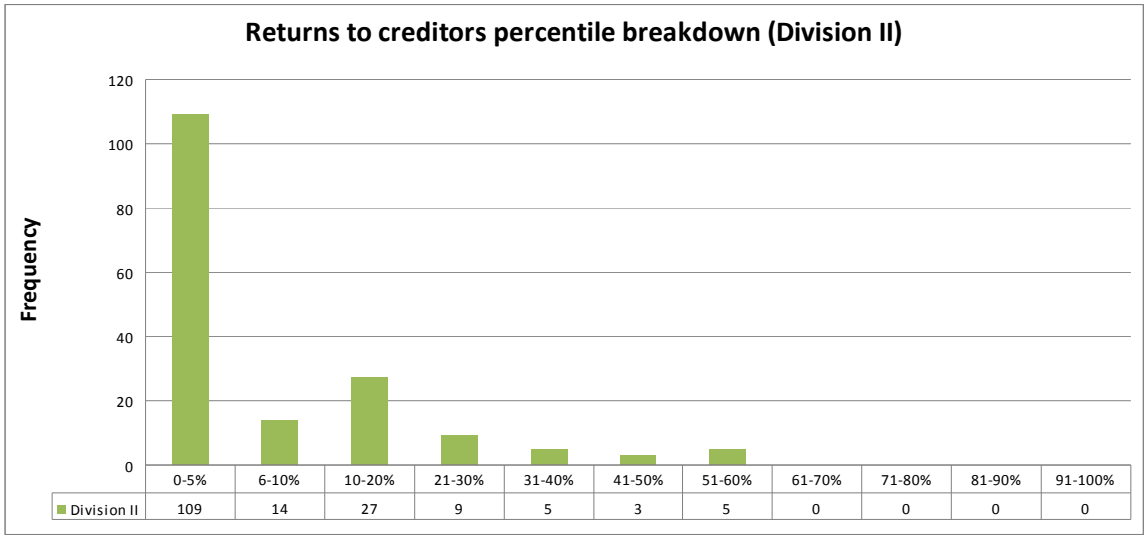
Graph 19 illustrates recovery by percentile for Division I proposals. Of the 50 files for which Division I proposals were completed during this period, in more than half of the files, the recovery is less than 5%, explaining the lower median value overall. However, in 12% of the cases, creditors received return on the value of their claims of greater than 20% of their claims. Adding in the next percentile, in 32% of the cases, creditors received return on the value of their claims of 10% or more.

Graph 19
Recovery to Creditors under Division I Proposals by percentile



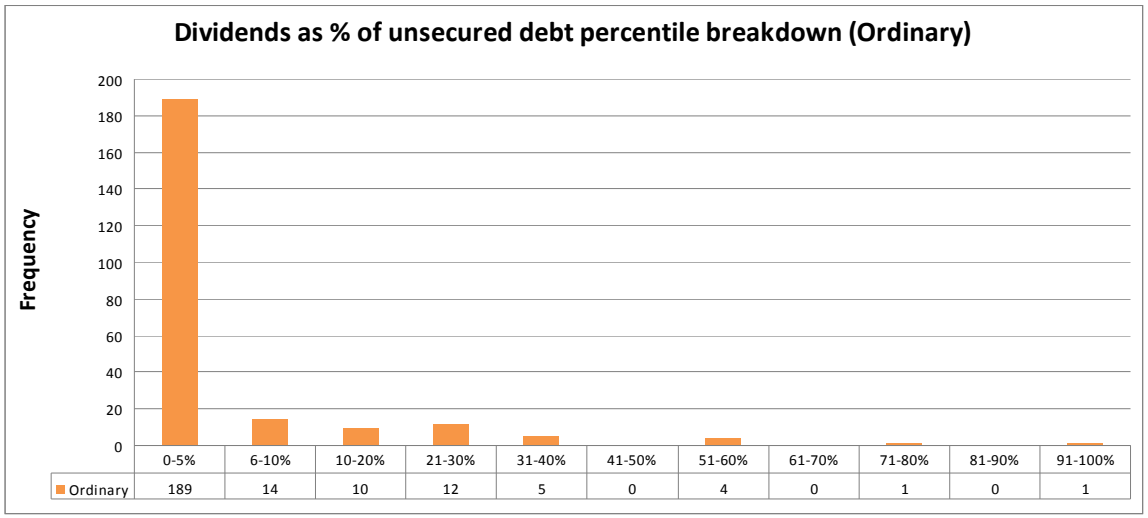
Graph 20 illustrates recovery by percentile for Division II proposals. Of the 172 files for which Division II proposals were completed during this period, in 63% of the files, the recovery is less than 5%, explaining the low median rate of recovery overall. However, in 12.8% of the cases, creditors received return on the value of their claims of greater than 20% of their claims. Adding in the next percentile, in 28.5% of the cases, creditors received return on the value of their claims of 10% or more.

Graph 20
Recovery to Creditors under Division II Proposals by percentile



Turning to bankruptcy proceedings, Graph 21 illustrates recovery by percentile for ordinary administration bankruptcies. Of the 236 files for which ordinary administrations were completed during this period, in 80% of the files the recovery was less than 5%, explaining the zero median value overall. In 10% of the cases, creditors received return on the value of their claims of greater than 20% of their claims. Of this number, only in two cases did creditors receive greater than 70% of the value of their claims.

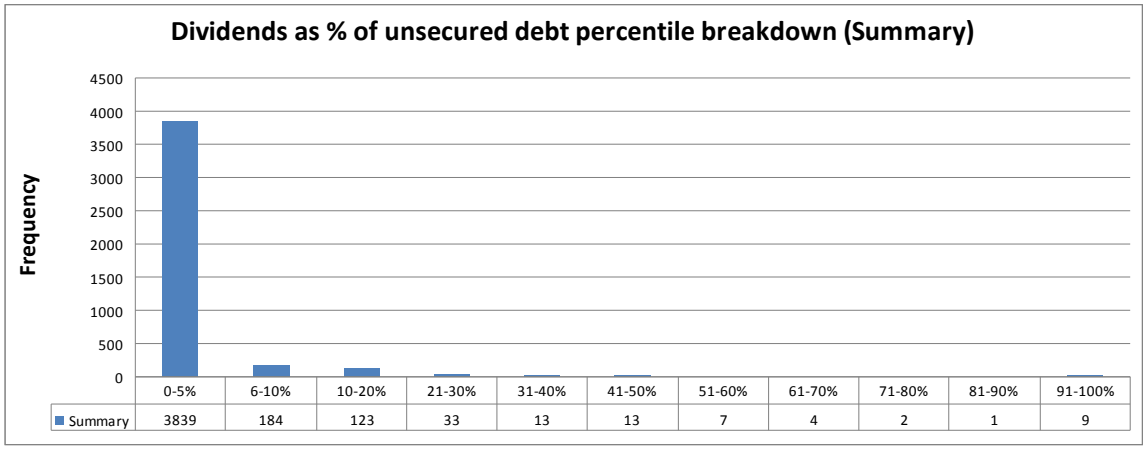
Graph 21
Recovery to Creditors under Ordinary Administration Bankruptcy by percentile



In terms of summary administration bankruptcies, Graph 22 illustrates recovery by percentile. Of the 4,228 files for which summary administration business-related bankruptcies were completed during this period, in 80% of the files, the recovery is less than 5%, explaining the zero median value overall.

In only 1.9% of the cases did creditors receive a return of greater than 20% of the value of claims. Of this number, creditors in nine files received 100% recovery of the value of their claims.

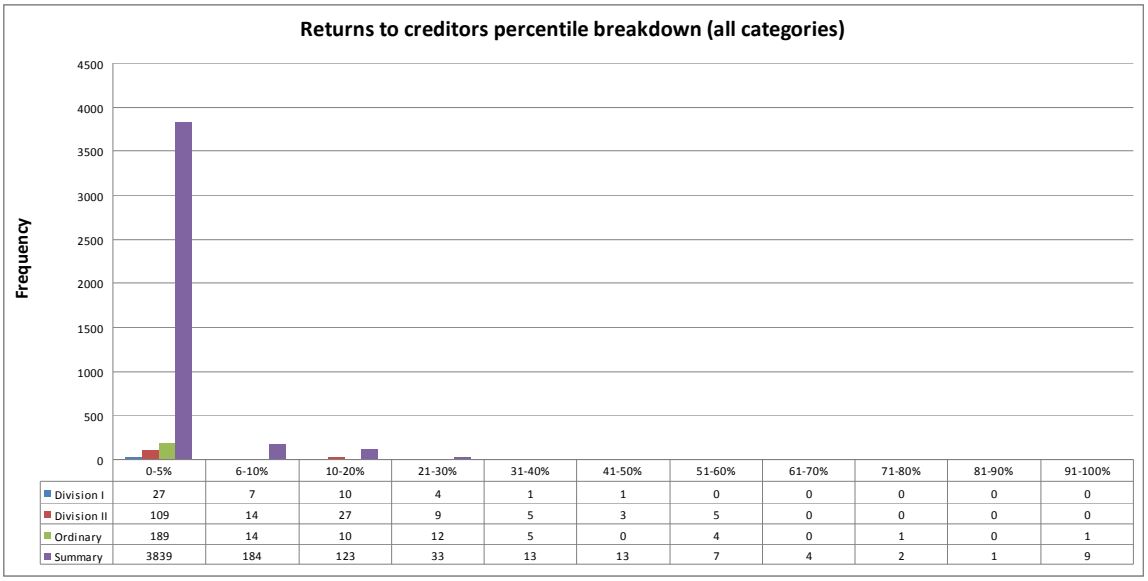
Graph 22
Recovery to Creditors under Ordinary Administration Bankruptcy by percentile



Hence, while there is higher recovery under business proposals than business bankruptcies, the recovery by percentage of value of creditors' claims is not as significant as might have been thought. However, it is higher than either bankruptcy option, also preserving in many cases the business, with additional benefits to creditors, including employees and suppliers.

Graph 23 is simply a composite of Graphs 19 to 22, illustrating visually the low recovery rates in respect of business insolvency and bankruptcy under the *BIA.*

Graph 23
Recovery to Creditors, all Types of Files



	0-5%	6-10%	10-20%	21-30%	31-40%	41-50%	51-60%	61-70%	71-80%	81-90%	91-100%
Division I	27	7	10	4	1	1	0	0	0	0	0
Division II	109	14	27	9	5	3	5	0	0	0	0
Ordinary	189	14	10	12	5	0	4	0	1	0	1
Summary	3839	184	123	33	13	13	7	4	2	1	9

VIII. ADDITIONAL FACTORS INFLUENCING TYPE OF PROCEEDING

There are a number of other factors that influence how an insolvent business deals with its financial distress. Several are dealt with in this part.

1. Receivership prior to Bankruptcy

One aspect of business insolvency is the use of receiverships. In 2008, receiverships were heavily used in Ontario, British Columbia and Alberta, and to a lesser degree in other Canadian jurisdictions, as illustrated by Table 12 below. Alberta had a 150% increase in the number of receivers in 2008 over the previous year.

For 2008, the OSB reports a decrease in the number of receiverships from the year prior, primarily court-appointed receivers, as illustrated in Table 14 below. Nova Scotia, New Brunswick, Newfoundland and Québec used private receivers exclusively. Ontario and British Columbia have a number of both court-appointed and privately appointed receivers, the latter more numerous, likely given that the appointing creditor has more control over the activities of a private receiver and the costs of realization tend to be less. Alberta is the opposite of the national trend, with 53 court-appointed receivers compared with 17 privately appointed receivers in 2008. The Table also sets out the amount of assets under receivership.

Table 14
Receiverships, 2008, OSB Annual Insolvency Statistics

	Volume			Declared Assets ($)
	2008	2007	% Change	
Newfoundland and Labrador	5	8	-37.5	2 012 923
Court appointed	0	0	—	0
Privately appointed	5	8	-37.5	2 012 923
Prince Edward Island	7	1	600.0	1 882 000
Court appointed	2	1	100.0	1 047 000
Privately appointed	5	0	—	835 000
Nova Scotia	32	23	39.1	9 996 095
Court appointed	0	3	-100.0	0
Privately appointed	32	20	60.0	9 996 095
New Brunswick	20	19	5.3	13 584 371
Court appointed	0	0	—	0
Privately appointed	20	19	5.3	13 584 371
Quebec	25	23	8.7	83 625 992
Court appointed	0	4	-100.0	0
Privately appointed	25	19	31.6	83 625 992
Ontario	294	393	-25.2	1 256 173 097
Court appointed	60	111	-45.9	178 802 000
Privately appointed	234	282	-17.0	1 077 371 097
Manitoba	24	10	140.0	45 458 792
Court appointed	3	3	0.0	2 209 108
Privately appointed	21	7	200.0	43 249 684
Saskatchewan	8	2	300.0	21 310 865
Court appointed	2	1	100.0	17 079 000
Privately appointed	6	1	500.0	4 231 865
Alberta	70	28	150.0	284 056 917
Court appointed	53	14	278.6	265 224 719
Privately appointed	17	14	21.4	18 832 198
British Columbia	75	66	13.6	99 085 850
Court appointed	24	20	20.0	70 248 923
Privately appointed	51	46	10.9	28 836 927
Northwest Territories	0	1	-100.0	0
Court appointed	0	0	—	0
Privately appointed	0	1	-100.0	0
Yukon	0	0	—	0

Court appointed	0	0	—	0
Privately appointed	0	0	—	0
Nunavut	0	0	—	0
Court appointed	0	0	—	0
Privately appointed	0	0	—	0
Canada	560	574	-2.4	1 817 186 902
Court appointed	144	157	-8.3	534 610 750
Privately appointed	416	417	-0.2	1 282 576 152

Sector data for receiverships is not yet available for 2008. Using 2007 data, receivers are more likely to be appointed in the manufacturing, wholesale sector, retail sector, and accommodation and food services than any other sector, as illustrated by Table 15 below, although in Ontario, they tend to be used in a broader range of sectors, as Table 16 indicates.

Table 15
Receiverships by Type of Industry (NAICS), Canada, 2007[180]

Type of Industry (NAICS)	Number of Cases	Total Assets ($)
Agriculture, Forestry, Fishing and Hunting	25	26,876,401
Mining and Oil and Gas Extraction	15	75,578,229
Utilities	5	212,596,356
Construction	22	12,846,967
Manufacturing	117	325,858,268
Wholesale Trade	48	89,475,032
Retail Trade	94	63,958,871
Transportation and Warehousing	23	17,829,092
Information and Cultural Industries	11	16,308,158
Finance and Insurance	30	31,462,160
Real Estate and Rental and Leasing	22	89,668,615
Professional, Scientific and Technical Services	22	172,168,451
Management of Companies and Enterprises	12	24,790,901
Administrative and Support, Waste Management and Remediation Services	4	8,532,947
Educational Services	2	1,602,948
Health Care and Social Assistance	3	7,162,671
Arts, Entertainment and Recreation	33	30,040,466

[180] OSB, as declared by debtors, As per NAICS major groups (1997).

Accommodation and Food Services	77	76,032,258
Other Services (except Public Administration)	17	3,676,134
Public Administration	0	0
Total	582	1,286,464,926

Table 16
Receiverships by Type of Industry (NAICS), Ontario, 2007[181]

Type of Industry (NAICS)	Number of Cases	Total Assets ($)
Agriculture, Forestry, Fishing and Hunting	5	16,122,809
Mining and Oil and Gas Extraction	4	1,931,755
Utilities	5	212,596,356
Construction	11	10,991,170
Manufacturing	80	303,561,150
Wholesale Trade	33	78,870,305
Retail Trade	60	57,282,538
Transportation and Warehousing	18	13,921,862
Information and Cultural Industries	9	15,486,972
Finance and Insurance	22	11,958,160
Real Estate and Rental and Leasing	14	66,143,390
Professional, Scientific and Technical Services	10	164,741,652
Management of Companies and Enterprises	8	23,958,006
Administrative and Support, Waste Management and Remediation Services	4	8,532,947
Educational Services	1	1,601,948
Health Care and Social Assistance	3	7,162,671
Arts, Entertainment and Recreation	28	28,033,466
Accommodation and Food Services	66	74,903,724
Other Services (except Public Administration)	15	3,675,134
Public Administration	0	0
Total	396	1,101,476,016

Trustees were asked about their experience in terms of receivership before bankruptcy. With respect to corporations, 76% of trustees surveyed answered in the negative, that generally businesses do not first go through receivership before bankruptcy. Corporations often file immediately for bankruptcy, affording the opportunity to take over supervision of the business immediately and offering the advantage of the scheme of distribution under the *BIA*.

[181] OSB, Insolvency in Canada, 2007, http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br01783.html, as declared by debtors, as per NAICS major groups (1997).

There are regional differences, however. Trustees in Newfoundland observed that there are only rarely corporate bankruptcies in that province; rather, the vast majority go to receivership, an interesting observation since there were only five receiverships in 2008. In Ontario, there are numerous receiverships where assets are liquidated without resort to bankruptcy proceedings. There may be a proposal out of receivership and liquidation through that mechanism, either privately, if there are few creditors or under the proposal provisions of the *BIA* where there are numerous creditors.[182] One trustee responded that when companies go through receivership, usually few assets are left to file for bankruptcy afterwards.

16% of trustees reported that frequently receivership and bankruptcy proceed co-concurrently, while 8% reported that this simultaneous type of proceeding no longer occurs with any great frequency.[183] The OSB was not able to provide data on the number of concurrent receivership and other proceedings. Such data would be helpful to collect in the future.

78% of trustees reported that sole proprietorships rarely go through receiverships. The reasons specified are that sole proprietors usually make an assignment in bankruptcy because they are dealing with relatively small value of assets, and usually file either a proposal or bankruptcy without a receivership. In small files, trustees reported that the auctioneer sells the assets, and there is often little reason to undertake both a receivership and a bankruptcy. When dealing with smaller business, it is not financially viable from a creditor's perspective to appoint a receiver.

One quarter of trustees surveyed responded that in the case of corporations and partnerships, businesses usually go through receivership before bankruptcy where there is debt that needs to be subordinated. Secured creditors frequently want a receiver appointed to take conservatory measures, conduct an investigation of the debtor with the assistance of the *BIA,* or recover losses. In some instances, the receiver is put in place to monitor the governance of the debtor business, where secured creditors are not confident of governance of the business during the proposal process in terms of the decisions being made by the debtor company.

The receivership decision depends on individual circumstances, and in particular, assets available to satisfy the claims of secured creditors. Two trustees pointed out that because of the size of corporate businesses, the banks play a major role in deciding whether it is in their interest to place debtors into receivership first.

2. Voluntary versus Involuntary Filing

In terms of voluntary versus involuntary filings, 97% trustees agreed that bankruptcy files are primarily voluntary for both corporations and sole proprietors. The reasons why proceedings are usually commenced voluntarily were explained by trustees in the following way.

First, the costs of involuntary bankruptcy are prohibitive, given that legal costs are expensive. For partnerships, usually when parties part ways, receivership will occur first and then bankruptcy occurs on a voluntary basis. For incorporated businesses, during receivership, the company will generally voluntarily assign the company to bankruptcy to minimize directors' or controlling shareholders' exposure under their

[182] Several trustees raised the *CCAA* as an option, but appreciated this study is regarding *BIA* proceedings.
[183] These data have been requested of the OSB but are not yet available.

personal guarantee. For involuntary files, the creditor has to take the initiative to file it, which is unlikely unless it is concerned about fraud or preservation of assets. Instead, creditors will probably just walk away if the debt is small, and not spend the money to make an application for a bankruptcy order. They might pressure debtors, but if debt is small, it is not financially viable to make an application for a bankruptcy order against the debtor. Pressure may encourage the filing of a proposal or assignment into bankruptcy. Trustees reported that applications by creditors are rare and often unsuccessful, plus more costly for the creditors for both corporations and sole proprietorship.

Creditors don't usually need to force a bankruptcy because debtors know when their business has failed. Trustees reported that most filings are voluntary because people know when the business cannot be continued. Notwithstanding the type of business, the principals recognize they cannot survive any longer and do not want to and or cannot afford the cost of litigation.

Bankruptcies are driven by unsecured creditors and recovery is somewhat limited. To force a bankruptcy, they have to file an application for a bankruptcy order, which requires that they guarantee the trustee's fees and often incur significant legal costs, and so the small recovery for these unsecured creditors makes it not financially viable to initiate the proceedings as the recovery will not justify the costs associated with the application for a bankruptcy order.

2% disagreed that bankruptcy filings are primarily voluntary, suggesting that in their practice, only sole proprietorships make voluntary filings, usually approach trustees on their own initiative to trustees when they get into financial trouble, whereas corporations are often involuntary because lenders usually appoint a receiver when the debtor gets into financial trouble.

3. Statutory Provisions that May Influence Type of Proceeding

Trustees were also surveyed with respect to what factors, in their experience, influence choice of proceeding. 40% of trustees reported that the statutory language of the *BIA* encouraged a choice for proposal. A majority observed that the notice of intention provisions have created considerable flexibility to make proposals, in turn, encouraging a greater number of business proposals.

Control over the process is a significant factor. Proposal is chosen because under bankruptcy, the OSB mandates the required amount of surplus income payments, whereas the debtor has greater control under a proposal. For high-income individuals, it makes more sense to file for proposal. Proposals are often chosen because it allows the debtor to keep the business operating.

15% of trustees find that aspects of the *BIA* discourage a choice of proposal. Several trustees suggested that the requirement of payments to the Crown plus all penalties and interest within six months under section 60 is a major impediment to completing a proposal, as often debtors cannot meet this requirement due to cash flow restrictions.

Another explanation for the way in which the *BIA* discourages proposals is that it can be hard for corporations to make proposals because creditors will not accept anything less than 100 cents on the dollar. Three trustees reported that companies do "side deals" that trustees are not aware of, and that creditors will often pressure debtors by saying they will vote against a proposal unless these side deals are agreed to. Such practices, cited by trustees in the survey, are not generally

reported to the registrar or the court at the approval stage. If they were, they would likely have a significant impact on the approval decision. Such activities merit further investigation, such as perhaps direct interview of debtors, if they were willing to be surveyed.

When the debt is settled for less than 100% on the dollar, there is debt forgiveness; that reduced debt becomes taxable income, which can be significant. Also, trustee reported that GST claims are included in the proposal as unsecured claims and reduced in the forgiven portion, giving rise to liability for over-recovery. These tax issues may discourage some proposals.

One observation was that the 30 day goods claim, where suppliers have rights to repossess goods, can sometimes encourage creditors to press for bankruptcy because in a proposal that provision is not available and companies can use the inventory as working capital.

Several trustees believe that trustees may be disinclined to continue operations that result in bankruptcy, due to obligations being placed on receivers in respect of Crown claims and other obligations. Because of the requirement for publication of bankruptcy in the newspaper, notice of first meeting of creditors etc, especially for corporations, publicity might be a deterrent to bankruptcy in some cases, particularly in smaller communities.

Trustees observed that the proposed 21 months for debtors with surplus income is likely to encourage more debtors to undertake proposals, as the gap between payments under bankruptcy and proposals will be narrowed. It will be interesting to see the bankruptcy versus proposals statistics in the next few years as a function of the amount offered in the proposal.

Another factor that affects the decision to file a proposal is the debtor's credit rating; specifically, will the credit rating be less badly damaged if the debtor chooses proposal over bankruptcy? Credit reporting agencies are giving individuals the same rating regardless of whether they file for bankruptcy or proposal. if the proposal fails, the debtor may face a worse credit rating for a longer period of time. Hence, there's no incentive to file proposals from a credit reporting point of view. This issue is incredibly important as a public policy question if the objective is to encourage proposals.

The study tried to discern whether business bankruptcy is being used more than once by some debtors seeking to commence or maintain their own business. For example, are there individuals that incorporate, then go bankrupt and shed their debts; then do the same thing all over again? Such a trend was not possible to discern from the electronic data. One option would be for the OSB to mandate more fulsome collection of data as to the individuals involved in a corporation that is insolvent, such as shareholder registers, past and present directors, incorporators, in order to track this information. A question on bankruptcy forms could be whether the debtor has ever been the director or officer of a bankrupt corporation.

However, the trustee survey produced some interesting observations in respect of this question. 38% of trustees answered that they have not seen business principals engage in repeat bankruptcies to any great extent, although half of this group acknowledged that it does happen infrequently. These trustees observed that there are many more repeat consumer bankruptcies than there are for businesses. 63% responded in the affirmative, although half suggested it is not a frequent occurrence. Several trustees observed that it occurs much less now than

it did in the 1980's when proposals were not an option. It is almost impossible to track, in part because different trustees are used and usually the business name differs. A number of trustees observed that many businesses that close down do not go through formal bankruptcy proceedings, but simply wind down. Two trustees reported that this phoenix type bankruptcy happens more in times when the economy is doing well, as restaurants or other small businesses are more likely to dump their losses and use this technique as their business strategy.

Trustees were also asked about liquidating proposals. One study in Québec of 13 business proposals found that the majority were liquidating proposals.[184] There is currently a public policy debate in respect of the efficacy of using restructuring proceedings as a method of liquidating, most of the debate occurring in respect of liquidating *CCAA* proceedings.[185] 69% trustees surveyed reported that liquidating *BIA* proposals are occurring, and 31% reported that they had not seen or used liquidating proposals. Of those who reported in the affirmative, a number reported that this occurrence is rare, while others observed that liquidating proposals are a growing phenomenon, in part because creditors want to avoid having to indemnify receivers. 15% of trustees observed that liquidating proposals are being used because there can be higher recovery and lower costs associated under proposal proceedings, benefiting all parties. Sometimes debtors can sell assets over time because the *BIA* gives them time protection; sometimes sales of particular parts of the business are used to fund proposals. One trustee commented that the liquidation of assets is already a form of proposal.

4. Selection of *BIA* Proposal Process instead of the *CCAA*

Generally, the highly codified *BIA* offers certainty and timeliness of the proposal process, and can be more cost effective for business debtors to restructure their business. The *CCAA* offers more flexible timing and terms, but can be very expensive, given the numerous court appearances before the supervising judge.

Trustees were surveyed regarding use of the *BIA* over the *CCAA.* 53% reported that the determining factor when selecting a proposal process under the *BIA* instead of the *CCAA* is the amount of debt, the vast majority of files not falling within the minimum 5 million CAD debt requirement for access to the *CCAA.*

Transaction costs that are associated with workout proceedings are also a significant determinant of choice of process. 34% of trustees reported that the cost of proceedings was a very significant factor, as the professional costs associated with the *CCAA* are very high, and therefore only larger corporations can access this avenue. These costs are in addition to general reorganization costs in terms of adjusting operations, implementing a new business plan, dealing with staff redundancies, and other costs associated with creating new credit arrangements and restructured business operations.

A number of trustees reported that the *CCAA* is more flexible if the debtor is able to access the statute. It depends very much on individual circumstances, and in

[184] Gosselin and Papillion, *supra*, note 11.

[185] For a discussion of *CCAA* liquidating plans, see Shelley C. Fitzpatrick, "Liquidating CCAAs - Are We Praying to False Gods?" and Bill Kaplan, "Liquidating CCAAs: Discretion Gone Awry?" in Janis Sarra, ed., *Annual Review of Insolvency Law, 2008* (forthcoming, Toronto, Carswell Thomson Reuters, 2009). See also *Cliffs Over Maple Bay Ltd.* (2008) BCCA 327.

particular, on the type of creditors involved. Other drivers include timing, as the *BIA* allows only six months for the debtor to devise and then achieve creditor support for a proposal. However, one trustee observed that "holding proposals" are frequently used, whereby creditors approve a proposal for purposes of the deadlines, and then vote to "amend" the proposal when the full proposal is developed, with that plan taken to the court for approval as an amended proposal.

Mindset is also a factor in choice of proceeding, in terms of a continuing stigma associated with proceedings under a statute with bankruptcy in its name. Another observation was that the *CCAA* can give debtors more control over secured creditors, whereas creditors more directly drive the outcome of *BIA* proposal proceedings.

78% of trustees reported that they do not have any experience with cross-border proceedings, and thus the survey did not produce informative observations in respect of whether the cross-border provisions in place now, or those proposed under the amendments, are effective in respect of cross-border proceedings. For the 22% of trustees with experience in cross-border proceedings, they reported that the mechanisms under the *BIA* and *CCAA* are equally effective and thus not a driver of choice of forum. One observation was that because the trustee's powers can be exerted anywhere there is a reciprocal agreement or recognition, cross-border provisions can assist in accessing the value of assets located elsewhere, but that there are no advantages from a debt point of view because legislation restricts debt to only Canada.

5. Debtor in Possession Financing for *BIA* proposals

Trustees were also canvassed in respect of their views regarding the use of debtor in possession (DIP) financing in *BIA* proposal proceedings. One half of trustees canvassed reported they had never sought DIP financing. One professional speculated that the number may actually be significantly higher. 53% of the trustees responded that DIP financing facilitates the ability of SMEs to utilize a proposal, as it makes it much easier for businesses to restructure.

DIP financing helps steer debtors to proposals or "loan to own" arrangements and away from bankruptcy. It is often obtained to help the business complete work in progress, and it benefits the creditors. DIP financing has increased the likelihood of successful proposals, as the financing is in place to assist with the effective implementation of a new business plan. The priority charge is the critical feature, as the DIP financing allows fresh capital to be injected in the business without fear of being subordinated to pre-existing secured lenders, providing businesses, particularly SMEs, with more options for remedying the insolvency. However, there are no data available on the number of proposals that have utilized DIP financing, so there are no firm conclusions that can be drawn in respect of the overall potential benefits. Anecdotally, trustees, debtor counsel and registrars report that such financing is almost non-existent for SMEs.

6. Pension Liability and Guarantee Funds as a Safety Net

Some insolvent businesses listed pension liabilities as a contributing cause of the insolvency of the business, although not a significant number. However, given the number of manufacturing and other sectors in decline where there has been strong unionization and thus strong pension plans, the pension deficiency issue is likely to grow. Part III above discussed recent amendments to the *BIA* to grant a priority to

pension claims in insolvency, both for bankruptcy and proposal proceedings. The only province that currently has a pension guarantee fund is Ontario, although such funds are prevalent in many jurisdictions such as the U.K., the U.S. and much of continental Europe. Such funds are a mechanism to offer relief for to employees and pensioners affected by business insolvency.

In Ontario, the Pension Benefits Guarantee Fund (PBGF) assists in situations where insolvent debtors are sponsors of a pension plan. It acts largely as a social safety net for employees and pensioners of plan sponsors whose insolvency risk has crystallized. Most of the assistance is for employees and pensions in a bankruptcy, as opposed to a successful restructuring proceeding under either the *BIA* or the *CCAA.* The PBGF has paid out claims from 107 plan sponsors with a total of 144 pension plans since its inception in 1983 to September 2007.[186] 75 of those proceedings were under the *BIA.*

The total amount of claims paid by the PBGF has been 883 million CAD.[187] Hence for pensioners and future pensioners whose plan is registered in Ontario, the fund offers some relief from losses due to their employer's insolvency, losses that would not be recovered in other provinces and territories. Of this total amount paid out, 70% were paid in proceedings under the *BIA.*[188] Recoveries amounting to 48.5 million CAD have been returned to the PBGF from the bankruptcy estates of plan sponsors in the same period.[189] The ability of the fund to recover, as a single creditors, from the estate, addresses the collective action problems faced by pensioners in pursuing their claims in a bankruptcy proceeding. Table 16 is illustrative.

Table 16
Pension Claims Paid from the Pension Benefit Guarantee Fund
1983 to September 2007 by Type of Insolvency Proceeding [190]

Type of Insolvency Proceeding	Plan sponsors with claims paid out by PBGF	BIA proceedings applying to PBGF by percentage	Number of sponsored pension plans	Total Amount of claims paid	Mean claims paid	Median claims paid
Voluntary assignment into bankruptcy *BIA*	24	32%	31	$ 53,315,315	$ 2,806,069	$ 1,024,100
Bankruptcy after *BIA* proposal	11		16			

[186] For a full discussion see, Janis Sarra and Ronald Davis, "Analysis of Factors Leading to Insolvency and Restructuring and their Effects on Pension Plan Wind-Ups and Closures", Report to the Ontario Expert Commission on Pensions, 2007.; FSCO, Total Claims paid as at September 30, 2007.

[187] FSCO, *ibid.* The issue of funding the PBGF is beyond the scope of this paper, and is being dealt with by other studies for the Expert Commission.

[188] While there were seven plan sponsors that filed under the *CCAA*, five were converted to bankruptcy proceedings and thus only two plan sponsors that completed *CCAA* plans of arrangement received claims from the PBGF.

[189] FSCO, November 8, 2007.

[190] Table created in Sarra and Davis, *supra*, note 186 using the following sources: Office of Superintendent of Bankruptcy; J. Sarra, UBC Law CCAA Database; and FSCO database, September 30, 2007, October 1, 2007 and November 8, 2007.

		15%		$ 25,746,117	$ 2,340,556	$ 682,300
Bankruptcy Application *BIA*	10	13%	13	$ 4,708,043	$ 411,211	$ 470,804
Privately Appointed Receiver	4	5%	7	$ 26,066,013	$ 6,516,503	$ 90,630
Privately Appointed Receivership followed by voluntary assignment *BIA*	8	11%	12	$ 19,390,357	$ 2,423,795	$ 1,270,776
Privately Appointed Receivership followed by a bankruptcy order *BIA*	8h	11%	10	$ 20,414,372	$ 2,551,797	$ 870,207
Court Appointed Receiver *BIA* followed by bankruptcy	3	4%	5	$ 4,894,411	$ 1,631,470	$ 1,943,900
Proposal *BIA*	2	3%	3	$ 13,568,836	$ 6,784,418	Not applicable
Bankruptcy order *BIA* after failed *CCAA* proceeding	5	7%	13	$190,704,266	$31,784,044	$ 4,207,599
Total under *BIA*	75	100% of BIA cases	110	$358,807,730	$ 4,784,103	$ 804,609

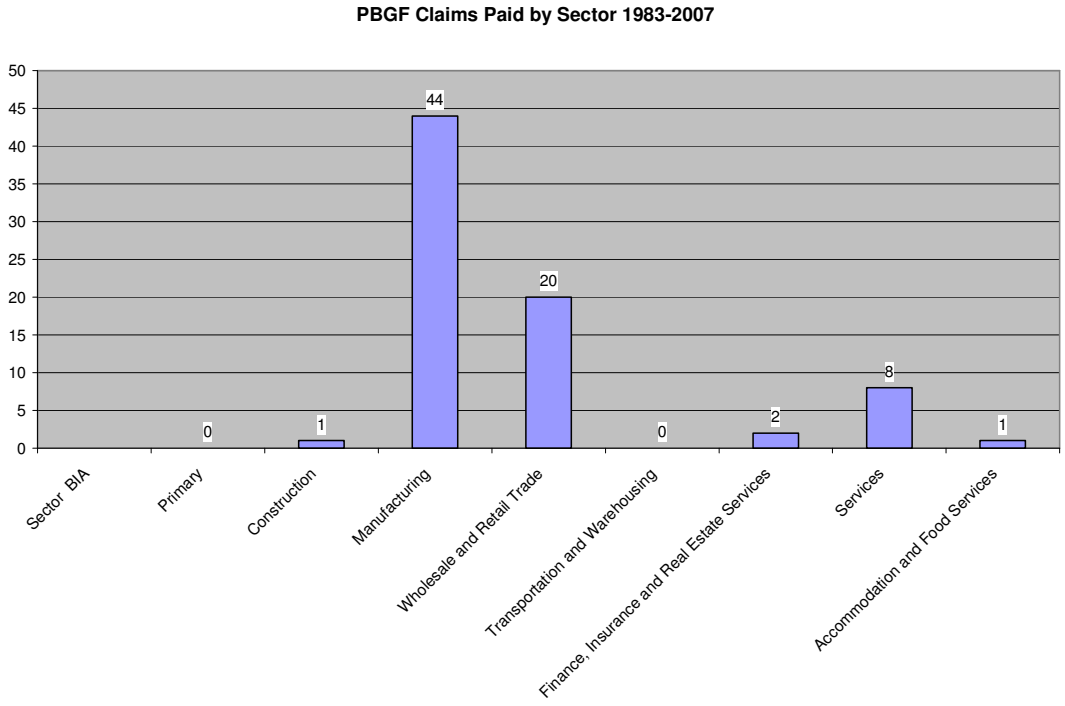
Of the *BIA* filings that received payments from the PBGF, 32% of insolvent businesses made a voluntary assignment in bankruptcy while 13% were the result of applications for a bankruptcy order by creditors into bankruptcy, triggering pension plan termination. 7% of the bankruptcies for which claims were paid out by the PBGF commenced as *CCAA* proceedings and subsequently were placed in bankruptcy, most often on a motion by the creditors. 15% of businesses attempted a restructuring under the *BIA* proposal provisions prior to being bankrupt and making a claim on the PBGF.

There were only two proposals under the *BIA* that did not end up in bankruptcy that resulted in claims paid out of the PBGF, not surprising because proposals can mean that pension plans are preserved or amended in a going forward restructured plan sponsor. There is no data available on the number of successful proposals for which there were unfunded pension liabilities that were resolved without recourse to the PBGF. To place the 13 businesses that filed proposal proceedings and made claims to the PBGF in context, there were more than 10,000 business proposals under the *BIA* in the same period.[191] In terms of employees in sectors that have been most assisted, Graph 24 below, illustrates payments by sector. The manufacturing sector comprises 44% of all payments made due to business insolvency.

[191] Office of the Superintendant of Bankruptcy (OSB), *Business Insolvency in Canada: a National and Regional Analysis for the Period 1987-2005*, OSB, December 2006, http://strategis.ic.gc.ca/epic/site/bsf-osb.nsf/vwapj/BusinessInsolvencyCanada1987-2005.pdf/$FILE/BusinessInsolvencyCanada1987-2005.pdf; *Insolvency in Canada 2006,* http://strategis.ic.gc.ca/epic/site/bsf-osb.nsf/en/br01702e.html; *Insolvency in Canada 2005,* http://strategis.ic.gc.ca/epic/site/bsf-osb.nsf/en/br01711e.html*; Insolvency in Canada 2004,* http://strategis.ic.gc.ca/epic/site/bsf-osb.nsf/en/br01711e.html.

Graph 24

PBGF Claims Paid by Sector 1983-2007 where there was a proceeding of plan sponsor under the *BIA*



Knowing the percentage of cases in which bankruptcy was the result is helpful in understanding the role of the PBGF in bankruptcy in terms of reducing risks to pensioners. Given that Ontario is the only jurisdiction in Canada in which there is a pension benefit guarantee fund, it seems evident that if such guarantee funds existed on a national basis, a significantly greater number of the *BIA* proceedings each year would involve claims for unpaid pension amounts owing.[192] Currently, there is no national protection for pensioners against insolvency risk in the same manner as Ontario offers through its pension guarantee fund. However, the new priorities for pension contributions will assist at least in some measure.

7. Current Delineation between Consumer and Commercial Insolvency under the *BIA*

Trustees were also asked to comment on how the OSB currently defines debtors for purposes of both ease of access to the process and longer term record keeping. Most of those interviewed found that the current delineation between consumer and commercial insolvency under the *BIA* was an appropriate delineation, although a number observed that trustees may not be appropriately marking the designation on forms because they do not appreciate the significance of accurate data collection for policy purposes. 20% of the trustees chose not to answer this question.

[192] OSB Annual Statistics, *supra*, note 5.

Trustees made the following observations. First, in consumer bankruptcy, trustees are usually dealing with a relatively simple process but with business, there is a lot more work involved, particularly for ordinary administration. According to some trustees, there is a problem when dealing with Canada Revenue as directors' liability for GST should be included in business debt because it flows from the business, but is not reflected in the data reported.

A number of trustees observed that the proposed amendments to raise the threshold for access to Division II to 250,000 CAD will be very helpful for sole proprietors and other small businesses because most borrow above the current 75,000 CAD threshold.

More than one third of the trustees reported that they do not agree with the current delineation between consumer and commercial insolvency, as it is an arbitrary number that does not reflect the nature of the business, it becomes an arbitrary judgment call as to whether the debtor is a consumer or business debtor, and it does not really align with Statistics Canada reporting of SMEs.

10% of trustees observed that personal debt and business debt are too often completely comingled, referred to by one trustee as the "one pocket" theory, making it difficult for both categorization and for determining what type of receivership or other proceeding is needed. In theory, delineating type of debtor by whether 50% is consumer or business debt makes sense, but in practice, it is much more difficult to make that determination. Several queried whether the distinction is important at all and whether it assists in answering any policy questions.

8. Resources for Small Businesses

A number of trustees suggested that information and resources for small businesses are considerably limited and should be enhanced. As a result, the study examined the types of information and services currently available. Below is a description of the programs. However, at least one trustee observed that the programs cannot be taken at face value, as they generally are not available to smaller businesses with little existing capital. There does not appear to be any empirical data that measures the effectiveness of the programs, particularly as a resource for SMEs.

The federal Small Business Finance Centre reports that there are currently about 39 federal and 57 provincial programs available to small businesses, offering between 1,500 - 500,000 CAD worth of funding.[193] There are information resources available from Canadian government websites designed to provide information to those considering starting up a small business. The "Canada Business – Service for Entrepreneurs" website includes search tools that allow a search for various types of financial assistance from the federal or the relevant provincial government, for a variety of business purposes.[194]

[193] Small Business Finance Centre, https://strategis.ic.gc.ca/app/scr/srcsFncng/instRgstrtn/Srch?lang=eng&stg=1&type=F&instTyp=G.
[194] *Ibid.*

Industry Canada provides considerable on-line information on starting, financing and managing a small business.[195] Industry Canada directs the small business person to hyperlinks that provide information on companies, statistics, financing, innovation, research, science and technology, intellectual property, radio, spectrum and telecommunications, regional and rural development, regulations and standards, sustainability and environment, and trade and investment.[196] It provides information on federal incorporation,[197] planning and management, and productivity and measurement tools.[198] There are services directed towards starting a business, financing, taxes and GST, managing, importing and exporting, e-business, and regulations, licenses and permits.[199] The Federal Government has information about numerous aspects of starting a business, organized by topic, province and territory; issues to consider before deciding to start a business; key factors for starting particular types of businesses; how to choose a business structure; and information on registering the business name.[200]

The Federal Government also offers tools that enable individuals to prepare a business plan.[201] There are general business plan guides available;[202] as well as more particularized business plans guides for retailers,[203] small construction firms,[204] small service firms,[205] and small manufacturers.[206] The Interactive Business Planner (IBP) is a software product designed to interactively help entrepreneurs to create a three year business plan for new or existing business.[207]

There are additional resources aimed at assisting small businesses in finding and managing financing of the business, including the Canada Small Business Financing Program and The Business Development Bank of Canada.[208] The Canada Small Business Financing Program is aimed at providing a financial resource for "establishing, expanding, modernizing and improving small businesses."[209] "Improving" may include businesses that are starting to face difficulties. Under the program, the federal government encourages financial

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[195] http://www.ic.gc.ca

[196] Industry Canada, "Resources for Businesses", http://www.ic.gc.ca/eic/site/ic1.nsf/eng/h_00140.html .

[197] http://www.ic.gc.ca/eic/site/ic1.nsf/eng/h_00145.html

[198] Industry Canada, "Business Tools and Resources", http://www.ic.gc.ca/eic/site/ic1.nsf/eng/h_00068.html

[199] Government of Canada, "Canada Business – Service for Entrepreneurs", http://www.canadabusiness.ca.

[200] Government of Canada, "Starting a Business", http://www.canadabusiness.ca/servlet/ContentServer?cid=1184863764589&pagename=CBSC_FE%2FCBSC_WebPage%2FCBSC_WebPage_Temp&lang=en&c=CBSC_WebPage

[201] Canada Business, "Preparing a Business Plan", http://www.canadabusiness.ca/servlet/ContentServer?cid=1184871442548&pagename=CBSC_FE%2FCBSC_WebPage%2FCBSC_WebPage_Temp&c=CBSC_WebPage

[202] http://www.canadabusiness.ca/servlet/ContentServer?cid=1081945275379&lang=en&pagename=CBSC_FE%2Fdisplay&c=GuideFactSheet

[203] http://www.canadabusiness.ca/servlet/ContentServer?cid=1081945275913&lang=en&pagename=CBSC_FE%2Fdisplay&c=GuideFactSheet

[204] http://www.canadabusiness.ca/servlet/ContentServer?cid=1081945276141&lang=en&pagename=CBSC_FE%2Fdisplay&c=GuideFactSheet

[205] *Ibid.*

[206] *Ibid.*

[207] http://www.canadabusiness.ca/ibp/en/

[208] http://www.bdc.ca/en/business_solutions/financial_services/default.htm

[209] http://www.ic.gc.ca/eic/site/csbfp-pfpec.nsf/eng/la00053.html

institutions to make financing available to small businesses by agreeing to reimburse the financial institution up to 85% of the lender's losses in the event of default. To be eligible, the business must be carried on in Canada, its purpose must be for profit, and the estimated revenues on the new or existing business must not exceed 5 million CAD.[210] Industry Canada is responsible for the administration of the Small Business Financing Program, but the financial institutions are responsible for all credit decisions, including assessing business plans, and for registering any loans they make with Industry Canada.

The Business Development Bank of Canada (BDC) provides loans for businesses that are just starting out or that have been established for some time.[211] Several trustees observed, however, that the program is particularly unwilling to lend to any business that cannot find loans from the chartered banks, and thus it does not provide an alternative for an SME with little existing capital or the inability to borrow elsewhere.

In addition, there is funding for specialized industries or for particular regions of Canada under Industry Canada Financing.[212] For example, businesses in the textile manufacturing industry may be eligible for funding from the Canadian government under the Canadian Textiles Program (CANtex).[213] There is a searchable inventory of funding and incentive programs to help develop, demonstrate and deploy environmental technologies. [214] There are several government financial resources available for manufacturers.[215]

FedNor is a federal regional development organization in Ontario to facilitate businesses growing in particular communities. [216] FedNor works to improve access to capital for small and medium-size enterprises in the Ontario North by working through a wide range of partners that provide financial assistance to Northern Ontario businesses that may not have the conventional means to finance.[217] In addition, the Community Future Development Corporations (CFDC) located in Northern Ontario can provide access to capital via loans, loan guarantees or equity investments, aimed at creating or maintaining employment.

The Seed Capital Program assists Atlantic Canada residents in starting, expanding or modernizing a business.[218] Aboriginal entrepreneurs and organizations may be eligible for funding through Aboriginal Business Canada.[219]

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[210] Applications for a loan under the Program may be made at any bank, credit union, caisse populaire and/or any other financial institution.

[211] http://www.bdc.ca/en/business_solutions/financial_services/default.htm. The BDC does not, however, provide grants or interest-free loans.

[212] http://www.ic.gc.ca/eic/site/ic1.nsf/eng/h_00006.html.

[213] http://www.ic.gc.ca/eic/site/ctp-ptc.nsf/eng/h_mn00001.html; under which the government may contribute a non-repayable amount of up to 50% of eligible project costs to a maximum of 100 000 CAD, and with a repayable contribution of up to 50% of eligible project costs to a maximum of 500 000 CAD.

[214] http://www.ic.gc.ca/eic/site/fte-fte.nsf/eng/home

[215] http://www.ic.gc.ca/eic/site/m20-f20.nsf/eng/00018.html

[216] Industry Canada, FedNor, http://www.ic.gc.ca/eic/site/fednor-fednor.nsf/eng/home.

[217] *Ibid.* FedNor reports that it stimulates investment in higher-risk enterprises by providing capital to community-based investment funds.

[218] Allowing a maximum of 20 000 CAD per applicant in the form of a repayable, unsecured personal loan, with flexible interest and repayment terms, as well as a maximum of 2,000 CAD per applicant for specialized training and business counselling. Another

While there is little information on specific assistance in respect of financially troubled businesses, the Business Development Bank of Canada provides loan refinancing, and loans for the reconstitution of depleted working capital.[220] It also provides subordinate financing, which may be critically important to those businesses that have already given security to other creditors, yet due to financial difficulty, have a need for immediate funds.[221] It may be that Industry Canada or the OSB should develop more information or consulting services on how to access programs where business debtors are facing financial difficulties, so that assistance can be offered before the point of business insolvency.

IX. FUTURE RESEARCH ISSUES - TRUSTEE VIEWS

The 50 trustees surveyed were also asked whether there are any other issues that they think should be a priority in respect of future research regarding insolvent businesses in Canada. Suggestions were extensive and varied, but can be classified into several broad areas.

The first is the relationship between the state and debtors. Almost half the trustees would like more research undertaken on Revenue Canada and how it affects restructuring of businesses and sole proprietorships, and the extent to which it deters viable workouts. Such research would be significant, but would require the cooperation of CRA, which may have little incentive to assist. Related to this suggestion was a call for research in respect of the attitude of the government as creditor at all levels, in that it can be very aggressive when seeking to recover what is owed, with potentially serious negative impact on the viability of SMEs.

The second most frequently recommended new research is in respect of the availability of new financing for small businesses experiencing financial distress. Trustees would like to see more information on access to capital pools or other financing, including whether there are regional or sector differences in accessibility to capital available for workouts, and options for bridge financing during proposal proceedings.

A number of trustees would like research undertaken on the relationship between insolvent businesses and failure to remit payments, as they often see a business supplementing cash flow with their unremitted source deductions. Investigation

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example is that purchasers or lessees of a vessel or offshore marine structure may be eligible for funding through the Shipbuilding and Industrial Marine Industry Program. The payment for the newly built or modified vessel or offshore marine structure must be financed by a lender or lessor who will receive the Program contribution to reduce the applicant's interest or leasing costs. http://www.canadabusiness.ca/servlet/ContentServer?pagename=CBSC_NL%2Fdisplay&lang=en&cid=1081944209127&c=Finance

[219] http://www.ainc-inac.gc.ca/ecd/ab/abc/index-eng.asp, funded by Indian and Northern Affairs Canada.

[220] Financing requests can be made to BDC online at: https://www.bdc.ca/en/no_navigation/Financing_Request.htm.

[221] That form includes a drop-down menu which allows the financing-seeker to state that s/he is seeking financing to reduce payables or for refinancing, etc. http://www.canadabusiness.ca/servlet/ContentServer?pagename=CBSC_MB%2Fdisplay&lang=en&cid=1111058666840&c=GuideInfoGuide; and http://www.bdc.ca/en/business_solutions/financial_services/default.htm?cookie%5Ftest=2.

could be undertaken in respect of the relationship between the build up of pension fund liability and eventual insolvency of the business. Three trustees would like to see an analysis of the work of the OSB task force investigating fraud, and its effectiveness.

Several trustees recommended additional research on how directors and officers could be held more accountable for business failure, including consideration of new requirements such as background checks, insolvent trading, and research into the consequences of their managerial decisions on business failure and on employees, particularly those with long service.

Trustees recommended future research in how creditors may become more involved in the insolvent businesses. They also recommend a study on how the levy charged by the OSB is being used and whether this use is effective. There was also a call for more research broken down by industry and regions, so that debtors and trustees can acquire a stronger sense of what is likely to lead to a successful proposal. They recommended additional investigation of the reliability of the insolvency data, and how causes of insolvency are reported.

Another area that requires research is credit ratings and how they influence choice of proceeding. Credit ratings rehabilitation differs as between proposals and bankruptcy and may create different incentives for choice of proceeding.

A number of trustees recommended research on the winding up of companies outside of formal insolvency proceedings. The rate of commercial bankruptcy filings is not indicative of the actual number of business failings and may severely underestimate the actual numbers of business failings.

Trustees also suggested research into the effects of the credit counselling programs. Research on the early indicators of distress of companies or sole proprietorships would also be helpful. One trustee wants to research fraud, lack of due diligence of lenders, and government-guaranteed small business loans and default rates. Another trustee wants to see the impact of cross-border shopping and e-commerce on small businesses.

All of these topics are under-researched in Canada, and would assist in future public policy development.

X. INITIAL POLICY OBSERVATIONS AND CONCLUSIONS

The data analysed in this study offer some new insights into business failure in Canada. While the figures vary slightly between the 6,743 files and the 50 trustees who offered their thoughtful comments, there are considerable consistencies in the information collected. This part offers some initial policy observations and suggestions. It is meant to facilitate further discussion about reform, not to offer a clear plan. The suggestions are made with the clear caveat set out in Part II in terms of the limitations and sometimes subjectivity of the reported data. Following a brief review of the causes of business failure, several policy options are discussed that address some of the causes identified by the study. These options are assessed on the basis of the potential efficacy, practicality, and conformity with legal and social norms concerning insolvency policy. Finally, the potential effects on business restructuring of the pending amendments to insolvency legislation are briefly reviewed.

In terms of causes of business failure, the data overall suggests that for incorporated businesses, poor management, insufficient business revenue, over-extension of credit and downturn in the economy are four significant causes of insolvency. However, larger businesses that file under the *BIA*, are more likely to have effective governance structures in place, and thus less frequently have problems with poor management as the primary cause. Public policy should generally be aimed at encouraging business innovation and entrepreneurship, and thus insolvency policy should be aimed more directly at encouraging business proposals and supporting restructuring when firms are financially distressed. It is the existence of a timely, cost-effective and viable insolvency regime that encourages individuals to start companies, take measured risks to commence and expand businesses and generate economic activity.

For sole proprietors, poor management or money mismanagement is a very significant cause of financial distress, with almost three quarters of trustees observing that this factor played a significant role in the insolvency. Other significant causes were overextension of credit, under capitalization of the sole proprietor's business, economic downturn and failure to pay taxes. Absent direct interviews with debtors and bankrupts, it is difficult to ascertain how long before the insolvency proceeding that the individual or company officers realized that they were becoming hopelessly insolvent; it is an area for potential future research. In the U.S., Ronald Mann has suggested that financially troubled individual debtors are delaying filing bankruptcy, what he has called the "sweat-box" theory of consumer lending, whereby credit card lenders encourage debtors to continue making payments on their high interest credit cards for a few months longer before they file, contributing to the lenders' profits, but exacerbating the amount of debt of debtors by the time they file, placing them in deeper debt and thus at risk of losing more of their assets to satisfy creditors' claims.[222] The same phenomenon may be occurring here, explaining in part the high credit card debt of sole proprietors at the time of filing.

Failure to pay taxes was found to be much more frequent than reported in the global data, suggesting that while it is a problem identified by trustees, debtors may be reluctant to declare this factor as a cause of insolvency at the outset of proceedings.

For partnerships, the causes tracked those of sole proprietorships to some extent, suggesting that the same kinds of challenges face partnerships as for businesses operated by single individuals. Under-capitalization of the partnership's business was a significant cause of insolvency, but that figure was considerably less than for sole proprietorship, indicating that while still a significant problem, partners may be more likely to assess capital needs and require each other to commit capital at the commencement of the partnership arrangement. On partnership failure, there is a withdrawal of capital and the partner seeking to continue the particular business may suddenly become under-capitalized. Overextension of credit is a principal cause of partnership failure, which may indicate that once the business commences, over-leveraging becomes a significant problem. Also significant for partnerships was insolvency due to a failed business relationship, with such failures being the primary cause in more than one third of cases reported by trustees.

Recent data in late 2008 and early 2009 indicates that the global economic downturn is rapidly becoming a primary cause of business insolvency and

[222] Ronald Mann, "Consumer Bankruptcy and Credit in the Wake of the 2005 *Bankruptcy Reform Act* and the 'Sweat Box' of Credit Card Debt", (2007) U. Ill. L. Rev. 375 at 398.

businesses that would otherwise be viable are having difficulty accessing bridge financing. The financial distress of large manufacturers, such as the auto industry, is having a significant ripple effect in terms of parts companies and suppliers, creating cascading financial distress.

There were numerous instances in which business debtors listed more than one cause of insolvency, for example, failed business losses combined with over-extension of credit and failure to pay taxes. It is important to note that there are frequently multiple contributions to financial distress that are not fully captured when reporting global statistics. In the case of corporations, these multiple causes were business related. For sole proprietors, multiple causes more frequently include over-extension of credit, mismanagement of money, medical bills and lost income from illness and/or relationship breakdown as the causes of business insolvency. It is impossible to measure the synergistic effects of these multiple causes or to craft general policy changes or principles, but they must be borne in mind when examining specific primary causes of insolvency.

1. Governance of the Business Enterprise

First, the study revealed that the real causes of business insolvency are not always reflected in the current filings. "Business failure" is frequently reported as the primary causes, without too much information on what underpins that failure. The free form text submitted does offer some insights in a sizeable portion of the cases, but the amount of description appears to vary considerably based on the particular trustee and the extent to which the trustee encourages the debtor to undertake a fulsome explanation. Where other principal causes are cited, a pattern emerges in respect of the reasons for failure.

Topping the list is poor management and/or money mismanagement, across all categories of incorporated entities, partnerships and sole proprietorships. Of the 702 filings in the 5,515 data set that had detailed information, one-third reported poor management of the business as a principal cause of insolvency. Trustees place that cause even higher in reporting on their practice experience. In some cases, the poor management related to failure of the business to have tranches of financing that can be drawn on when there is a downturn in the business.

While effective corporate governance has been a major aim of both corporate and securities laws for the past two decades, it appears not to have permeated to numerous businesses. The more detailed data suggest that it is not just poor management of accounts, but failure to have a realistic business plan, to plan for foreseeable contingencies, and in many cases, the comingling of business and personal debt, which in turn can jeopardize other family as well as the individual business person.

Unless a company is seeking capital in the public market, there is no requirement for an effective governance structure under corporate or partnership law. These laws, which are aimed at the enabling of business activity, could be enhanced to require basic standards of governance, not unlike their current requirements of basic fiduciary obligations. Often the internal expertise of a small company includes geologists, engineers and other professionals in the sector that the company is engaged in; and the officers of the small business have not yet hired much financial expertise. Small businesses often have relatively fewer managerial resources. Small businesses, particularly those that are relationship-based, may have difficulty meeting independent director best practice requirements; and many have not

invested in governance structures and controls. Such controls may be thought to be unhelpful, directing valuable resources away from developing the business.

Even when a small business decides to go to the public market for capital, it tends to rely on underwriters and other professionals, rather than acquire in-house skills. Managers are often aware of regulatory requirements, but can feel daunted by their complexity. Sole proprietorship in this respect is more problematic, as anyone can get a business number and commence activities, without any form of governance in place.

Partnerships and small businesses may fail to have an exit strategy when the business is highly dependent on the cooperation of the principals and the relationship deteriorates. Exit strategies should include viable financing options to prevent relationship breakdown from precipitating an insolvency.

These observations are not to suggest that small businesses should be saddled with onerous governance structures that are inappropriate for the size and finances of the business. Too much regulation can be an obstacle to small business finance and participation in the public market.[223] Due to fixed compliance costs, small firms are disproportionately affected by any new regulatory requirement because of fewer resources and because the costs of compliance per dollar of revenue generated is higher than for bigger companies, as they need to source external auditing or legal work. The cost of compliance with regulatory requirements can frequently be disproportionate to the need for such controls given the size of the business. On the other hand, there is some public policy obligation to protect unwary creditors who are dealing in good faith with businesses. Our system of personal property protection and real property registration offer one means. Ensuring very basic governance standards would also assist in meeting such a goal. All businesses of any size can benefit from a viable, appropriate business plan, basic skills in governance, accounting and planning for contingencies, and assistance at early stages of financial distress.

i. Business Education and Training

The OSB could offer guidelines that assist small business to revise business plans before they reach the point of insolvency or could make grants available for small and medium enterprises to subsidize the debtors to employ financial expertise. One question is how to exercise oversight of such a program. One possibility is to require the filing of the business plan annually with the government with the tax refund, which should be relatively accessible given the on-line resources discussed earlier in respect of formulating business plans.

The point at which the proposal trustee or bankruptcy trustee enters the picture is late in the process of financial distress and businesses that might otherwise have been successfully restructured are liquidated. Moreover, trustees are not

[223] H. Y. Chiu, "Can UK Small Businesses Obtain Growth Capital in Public Equity Markets? An Overview of Shortcomings in UK and European Securities Regulation" (2003) 3 Delaware Journal of Corporate Law 933-977; Ontario Securities Commission, Task Force on Small Business Financing, Final report (1996), http://www.osc.gov.on.ca/About/Publications/op_small_business.pdf; Ginger Carroll, "Thinking Small: Adjusting Regulatory Burdens Incurred by Small Public Companies Seeking to Comply with the Sarbanes-Oxley Act", (2006) 58 Ala. L. Rev. 443; Interim Report of the Committee on Capital Markets Regulation, 30 November, 2006, online: http://www.capmktsreg.org.

necessarily qualified to advise on governance, as their skills are in the financial aspects of insolvency and restructuring.

The data suggest that governance practices can be early indicators of small business financial distress. The first is lack of business training in advance of commencing the business, including how to properly undertake basic accounting, lack of a business plan, and failure to track expenditures and revenues. One recommendation that can be clearly drawn from the data, whether the reported electronic data or the trustee survey is the need for considerably more education and skills building in the area of small business management. Although the degree of lack of skills training could not be discerned from the business insolvency data, it was very clear that mismanagement of resources or poor business management is a significant cause of small business failure. There could be considerably more resources devoted to assisting sole proprietors to commence their business.

There could be mandatory on-line courses before new businesses could be registered. While such education would not guarantee good governance practice, it would alert individuals engaging in business that there are multiple aspects to consider in commencing or taking over a business. A model could be university ethics training programs. Currently, universities require mandatory on-line ethics training for researchers planning to research with populations. For the experienced researcher, the several hour course and text can be completed quickly; for the less experienced, there are tutorials and then tests to ensure that the researcher has acquired a measure of understanding and skill in respect of ethical standards. Similar programs could be developed for small business management, easy to complete for those with the skills, and tutorials to assist those without. The resources offered by government should be more widely utilized, and the materials should be revised by Industry Canada to discuss risks of financial distress and avenues for prevention or addressing it.

The policy option of mandatory courses raises three important questions. The first is who will bear the costs of such programs. If the government pays, spreading the costs across the tax base, do the costs of such programs outweigh down-stream costs of the social safety nets that must be accessed when businesses fail. If the individual seeking to set up a business is to bear the cost, will such a requirement deter individuals from going into business or decrease the number of small business registrations, in terms of slowing entrepreneurial activity. There is also a question of computer literacy for some individuals, although that issue may be on the decline. Such a requirement may also raise barriers for those individuals whose first language is not English or French. There may also be arguments that mandatory training should not be required for philosophical reasons, although there are many requirements for entry into many professions and jobs, considered part of the costs associated with the benefits that individuals will ultimately realize. A similar logic may be appropriate here, particularly as small businesses benefit from public resources, such as exemptions from GST where income is low, and a lower tax rate.

Mandatory training would be quite intrusive in the marketplace. The only effective method of ensuring compliance would be to link it to obtaining a business number or it might work if the credit granting community required it as a condition of lending. It is unclear whether any appetite for such a requirement would exist with the institutional lenders. One concern is that a mandatory training requirement would just result in a greater underground marketplace. One issue is whether business debtors would be precluded from access to the *BIA* if they did not take the mandatory training. Such an option might be a social policy answer, in that if

the debtor wants the relief from its business failure, it must undertake the initial social burden of undertaking some managerial training during the proposal proceeding.

Another challenge to such a mandatory requirement is that it may affect the contractual nature of proposals. In the context of a recent *CCAA* plan, Justice Blair of the Ontario Court of Appeal observed that a proposal under the *BIA* is a contract between the debtor and its creditors.[224] Unlike bankruptcy, under a proposal, property and management remains with debtor and does not vest with trustee; and in this legal context, it may be problematic for the proposal trustee to advise the debtor that it lacks management skills and may be excluded from filing a proposal unless management is replaced, particularly for small businesses, where managers are often also principals in terms of equity investment in the business. Arguably, at least some governance concerns are addressed by creditor control at the approval stages. Creditors may reject a proposed proposal because they have serious concerns about the governance or management of the debtor. In some cases, there may even be hostility towards management by creditors at a creditors' meeting, which may force the debtor to consider alternative arrangements or incorporating particular changes or undertakings in the proposal before it will receive the requisite support. However, creditors face collective action problems in pressing for governance change. There are problems with creditor participation at meetings, particularly where the size of claim does not justify the resources to dedicate to exercising participation and control rights. Thus creditors may not always serve as a governance check.

Similarly, corporate governance issues can also be raised before the registrar in bankruptcy or the court at the approval hearing of the proposal, although, if there is the requisite amount of creditor support for the proposal, the court is unlikely to refuse approval of a proposal based on governance practices where parties do not raise the issue. There is no data available on the extent to which such issues are raised either by the parties or the registrar or court, an aspect that could be helpfully explored in further studies.

ii. Incentives for Lenders

A different approach would be to create incentives for commercial banks to increase both their lending and monitoring practices in respect of smaller businesses. Operating lenders are better positioned to extract governance covenants and monitor the debtor's financial situation than unsecured creditors. The data suggest that creditors could be more diligent in their monitoring, such that insolvency risk does not unnecessarily deepen as the debtor experiences various challenges to its finances. It seems inappropriate that financially unsophisticated business people, particularly tradespersons who are competent in their field, founder in a small business due to unwise credit decisions of which their lender should have been aware. Given the degree to which personal assets are also at risk through non-incorporated status or personal guarantees, there is perhaps a greater obligation on lenders to make lending decisions on real capacity to lend. Arguably, there may be a fiduciary obligation depending on the type of relationship

[224] *ATB Financial* v. *Metcalfe & Mansfield Alternative Investments II Corp.,* [2008] O.J. No. 3164, 2008 ONCA 587, at para. 9; Application for leave to appeal dismissed without costs (without reasons) September 19, 2008 [2008] C.S.C.R. no 337, citing *Employers' Liability Assurance Corp. Ltd. v. Ideal Petroleum* (1959) Ltd. [1978] 1 S.C.R. 230 at 239; *Society of Composers, Authors & Music Publishers of Canada* v. *Armitage* (2000), 50 O.R. (3d) 688 at para. 11 (C.A.).

between the bank and the debtor, particularly the sole proprietor.[225] However, as discussed in the "shifting nature of credit" discussion below, precisely the opposite is occurring, making it unlikely that banks will be the drivers of better governance practice as a requirement in lending decisions.

iii. Enhanced disclosure and Data Collection

While there was not sufficient data to make broad generalizations, it appears as if governance was less of an issue for publicly traded companies, likely because under securities law, they are required to disclose their financial status on a periodic basis over the year, to disclose governance structures, and to disclose on an ongoing basis any material changes likely to affect the business. Thus most companies have their governance practices in place to meet both statutory disclosure requirements and best governance practices.

In addition, as observed earlier, the OSB could mandate more fulsome collection of data as to the individuals involved in a corporation that is insolvent, such as past and present directors, incorporators, in order to track phoenix bankruptcies, using a question on bankruptcy forms asking whether the debtor has ever been the director or officer of a bankrupt corporation.

In summary, two basic ideas can be drawn from the study in respect of governance and business insolvency. First, there should be a standard of minimum business skills and basic business plans for the commencement of new businesses, with the government offering resources to ensure access to training on basic financing, governance and debt management, or to allow debtors to seek professional assistance in putting good governance practices in place. Second, a working principle could be that where the creditors and the trustee have identified a problem with the governance of the business, the debtor should not generally be allowed to restructure unless the governance concerns are addressed, either by bringing in new managers, retraining existing managers, or sale of the business as a going concern where new equity owners replace those governing the business.

However, under such a model, the concerns above would have to be addressed. The addition of another mandatory term may create another barrier to proposals. Moreover, unlike bankruptcy, under a proposal, property and management remains with debtor. In this legal context, there is a question as to whether a proposal trustee is really placed to suggest that the debtor cannot file a proposal unless management is replaced or retrained. The trustee may not have the skills to make governance recommendations, as its expertise is accounting and financial management, not other governance aspects of the business. It may be that governance concerns or controls are better achieved by creditor control and court control at the approval stages. Creditors may reject proposals at the creditors' meeting where they have serious concerns about the governance or management of the debtor.

iv. Control through Access to DIP Financing

[225] See for example, *Lloyd's Bank Ltd.* v. *Bundy*, [1974] 3 All E.R. 757, where the court held there was, in the circumstances, a duty of fiduciary care owed by the bank because of the confidential relationship between the bank and the defendant.

The proposed statutory amendments on debtor in possession financing, will, however, offer a mechanism for creditors and the court to put their minds to the governance practices of the debtor business. Proposed section 50.6 of the *BIA* codifies the court's authority to order DIP financing for insolvent companies. DIP financing will also be available to insolvent individuals where they are carrying on a business in relation to property acquired for or used in relation to the business. In deciding whether to make an order, the court is to consider, among other things, how the debtor's business and financial affairs are to be managed during the proceedings; whether the debtor's management has the confidence of its major creditors; and whether the loan would enhance the prospects of a viable proposal being made in respect of the debtor, all allowing for an assessment of the governance of the debtor.

2. Capitalization of the Business

Second, is the issue of adequate capitalization of the business. Of the 702 files with detailed descriptions of causes, 11% reported that the business had been under-capitalized. Trustees reported under-capitalization as even a greater problem. Under-capitalization appears to be most frequently a problem with sole proprietorships, but a stated principal cause of insolvency for partnerships and corporations as well. In terms of sole proprietorships, it is evident from the data that businesses are often commenced with inadequate capitalization at the outset. For partnerships and corporations, capitalization at commencement of the business appears to be less problematic, and under-capitalization appears to occur when the business decides to expand or move its activities in a different direction and adequate capital is not raised. When a partnership breaks up, if one or more partners wish to carry on the business, often the costs of buying out the exiting partner or partners results in the business becoming under-capitalized. Even companies that are sufficiently capitalized may not have made bridge financing arrangements for a deep and sustained financial downturn such as being experienced in 2009. Given that only some files have this degree of descriptive detail, one cannot make reliable observations. Yet it may speak to the type of resources or information needed at various levels and points of business activity.

Here again, education in respect of what is involved in running a business could serve as a preventive measure, in terms of creating realistic expectations of what is required in terms of capital to start up, operate or expand a business. There should be greater skills training and information on the need for adequate capitalization of the business, as well as more public information on potential sources of capital when a business begins to experience financial distress. Although the federal government and related entities have engaged in some of this education, there does not appear to be sufficient information in respect of risk of business failure and preventive strategies. The OSB has produced financial guides for consumers of all ages, including children and young adults.[226] The OSB could work with community and professional organizations, including the Canadian Insolvency Foundation and the Canadian Association of Insolvency and Restructuring Professionals, to develop a series of educational materials for high school and adult education that would allow individuals to develop basic business, financial management, and accounting skills, which would at least alert them to the challenges of later commencing a business or taking responsibility for a business without any formal training, and in particular, offer education regarding signals in respect of financial distress.

[226] See, for example, the OSB, *Financial Guide for Students,* http://www.ic.gc.ca/eic/site/bsf-osb.nsf/vwapj/FG_13-15_E.pdf/$FILE/FG_13-15_E.pdf.

3. Overextension of Credit

Overextension of credit is also a significant factor in respect of business insolvency, both in terms of the degree of leveraging from bank and other operating and capital loans, and credit card usage. The large data set revealed that 24% of business debtors reported over-extension of credit as a significant contributing cause. Credit card debt is particularly a factor in failure of smaller businesses.

Operating loans continue to be significant for all types of businesses filing under the *BIA*, but also, credit card debt has become significant as a source of financing, with average credit card debt of 19,795 CAD, and the median amount of credit card debt 7,000 CAD. Credit card debt has become a major contributing factor to the amount of debt carried by individuals involved in small businesses. Given the high interest rates on credit cards, debtors that do not have an income stream to cover the minimum payment are more likely to default on the credit card payments.

The data suggest that businesses incur considerable credit card debt in the period leading up to insolvency filing, frequently being used to cover expenses when revenues declined and the value of receivables outstanding increased. In many cases of business insolvency, the high percentage of credit card debt is not an issue of "abuse of credit cards"; rather, it is an unwise business decision at a time of business financial distress. When other credit is not available, SMEs may have no choice but to rely on credit card debt, in turn increasing the potential for insolvency in many cases. The data indicate that finance loans are often taken out in the period prior to filing in an effort to consolidate credit card debt. Bankruptcy proceedings become a means of relieving the financial distress and having a "fresh start" in terms of the credit card debt.

Professor Ronald Mann has observed that to the extent that credit cards have facilitated entrepreneurial activity, they have been an important component of a modern economy, but that there are social costs associated with credit cards, in the form of financial distress and an increase in individual bankruptcy. [227] He observes that excessive credit card debt can impose substantial costs on the debtor, family members and the general welfare safety net; as well as cost consequences from the diminished productive activities of those individuals in financial distress.[228] While the granting of credit card credit is a decision of the lender, it is not clear that small businesses appreciate the effects of cumulative interest rates. Elsewhere, Mann has suggested that unlike loans, where there are fixed interest and payment dates with credit card debt, debtors face high interest rates and no fixed payment schedule, other than minimum payments. Thus it is too easy to let those debts accumulate over a period of time.

Loans from individuals comprise a significant source of debt, primarily for sole proprietors, often from family and friends. Taxes owing comprise a significant source of debt, with an average of 41,477 CAD. However, the median amount was only 3,520 CAD, suggesting that there are fewer business debtors that owe a significant amount of taxes. Trustees observed however, that business debtors are increasingly using taxes owing as a source of credit.

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[227] Ron Mann, *Charging Ahead, The Growth and Regulation of Payment Card Markets,* (Cambridge University Press, Cambridge, 2006) at 3.
[228] *Ibid.* at 49-50.

Sole proprietorships continue to largely use conventional forms of credit, although the trustee survey revealed that payday loans have been used where the individual is both operating a business and receiving a paycheque from other employment, using pay day loans for access to ready cash for the businesses.

Given that tax debt is significant in at least some cases, arguably there is a role for Customs and Revenue Agency is terms of collecting debts in a timely manner and not encouraging the practice of using GST money as another form of credit. Similarly, for debtor companies with defined benefit pension plan, pension regulators should move in a much timelier manner to require businesses to cure pension deficits so that employees and pensioners are not inappropriately bearing these costs on business insolvency.

In summary, while credit is an essential aspect of financing business innovation and activity in Canada, there continues to be a significant problem of under-capitalization and over-extension of credit, which may lead to unnecessary business insolvencies. The principle should be that credit is available to businesses where the business has a viable business plan; and individuals should receive independent financial and legal advice before they use all their personal assets to provide security for creditors of the business. There should be much more education of individuals involved with SMEs in terms of understanding the risks and benefits of credit card debt and the need to balance forms of credit in the financing of the business. There also needs to be a renewed public policy debate in respect of the obligation of banks to ensure a market for small business loans, so that SMEs are not driven to finance their business through credit cards. There is also a question of whether there should be at least some regulation of credit card companies, ensuring that there are basic checks and balances built into the lending arrangement such that credit card debt is not used inappropriately to over-leverage the small business. They should be consideration of what obligations credit card companies may have to ensure that the debtor can bear the costs of the amount of credit granted. These issues need further policy consideration, given the significant role over-extension of credit plays in small business insolvency.

4. Economic Downturn

One of the most exciting and frustrating aspects of empirical research in insolvency is how dynamic the data are. Here, the study covered the period of 2005 to 2008 prior to the worse effects of the current global financial and economic situation. The observations in this part are dated even as the report is finalized in early 2009, given the tremendous challenges currently faced in Canada in respect of business financial distress. Even though most of the period studied was prior to the current financial crisis, 10% of business debtors reported that an economic downturn in their sector or the economy was a factor in the insolvency. This figure is rapidly rising in 2009. There are two types of challenges faced by businesses. The first is a loss of demand in the particular sector in which the business operates, which may be temporary or which may be a permanent loss. Different strategies are called for depending on the expected length or permanence of the market shift. Temporary market shifts require the business to have a strategy to survive the period, including access to bridge financing. Permanent market loss requires an assessment of whether the business can shift the core of its activities to meet new market demands, using credit to enable it to shift those activities, or whether it is most appropriate to wind it down.

The second type is a more general economic turndown or a market crisis, such as the current financial crisis. In such situations, credit is tighter and more costly at a

time when business may particularly need to access credit to weather the economic downturn. Business insolvency is likely to rise as the ripple effects of a credit freeze begin to manifest themselves in the real economy. This effect appears evident in cases filed from September to December 2008, where market crisis and market failure begin to enter the reasons for insolvency in a noticeable manner.

Another question in terms of the current financial climate is the relationship between tightening credit conditions and lack of confidence by both lenders and debtors of the efficacy of a proposal strategy to address the business financial distress in the current climate. Given how fundamental economic activity is, there should be public policy discussion in respect of how to ensure that proposals as a going forward strategy are meaningful during this period. Otherwise there may be a significant increase in premature liquidations.

Given that all businesses must try to adjust their business plans to meet market changes, there may be no specific recommendations, except to observe that businesses need more information on accessing credit in tight credit markets. Bankruptcy, banking and other policies need to reflect the need for affordable and accessible credit.

SMEs also need better information on the nature of particular financial products in the market and the risks associated with them. The asset-backed commercial paper market is a good example. There were a number of small businesses that had placed capital in ABCP because they were advised that it was a secure form of investment. Losses associated with the freeze of the market created some financial pressure on those companies, and losses may affect business solvency. More transparent markets in the future and better education of managers in respect of the risks associated with structured financial produces could assist in mitigating the risks to the business on an ongoing basis.

5. Shifting Credit Relationships

There is another aspect to the credit relationship with operating lenders that did not surface in the data studied, but which merits note.[229] The use of credit derivatives has arguably reduced the monitoring by traditional lenders, which may in turn both contribute to deferred insolvency and hinder restructuring of businesses. Credit derivatives are financial instruments that allow parties, including many operating lenders, to manage credit exposure.[230] Commercial banks as operating lenders traditionally had a strong role in monitoring the financial status of business debtors, particularly in the period leading up to insolvency. However, their hedging of risk through derivatives has reduced the incentive to engage in oversight and

[229] For a discussion of this issue, see Janis Sarra, "Credit Derivatives Market Design, Creating Fairness and Sustainability", NSFM, October 2008.

[230] There are numerous kinds of credit derivatives, such as credit default swaps, collateralized debt obligations (CDO), full and index trades, and credit-linked notes. Credit derivatives are classified as either single or multi-name (basket) products. Single name credit derivatives are targeted on the credit worthiness of a single reference entity. Multi-name products hedge the risk of clustered defaults in a portfolio. Elizabeth Murphy, Janis Sarra and Michael Creber, "Credit Derivatives in Canadian Insolvency Proceedings, 'The Devil will be in the Details'", in *Annual Review of Insolvency Law, 2006* (Toronto: Carswell) at 187-234.

monitoring, notwithstanding that they are best placed through loan covenants, access to information and in-house resources to engage in that monitoring.[231]

Given the weaker covenants under which some debtor companies have financed their operations in recent years because operating lenders were hedging risk through derivatives rather than rigorous covenants, other creditors may be unable to assert control over a debtor until there has been a significant deterioration in its financial position, leading to deferred liquidation or restructuring and consequent lower recovery to creditors.[232] It may no longer be feasible for the traditional operating lenders to take a lead in restructuring negotiations, given that they may have little or no remaining economic interest due to their credit default swaps. Originating lenders may be less willing to expend the time and resources to undertake due diligence in undertaking credit arrangements, as risk is laid off through derivatives under the originate and distribute model. Hence the signalling to the market that occurred with the decision to lend is no longer reliable as a measure of the firm's value.

Second, in the purchase and sale of credit derivatives, parties have frequently given up the negotiation of terms and conditions, including monitoring, restrictive covenants and default control rights, because they know that they will offset their own risk through other structured financial products. When the business begins to slide into financial distress, corporate stakeholders no longer share a common goal of maximizing firm value and constraining managerial slack because the originating lender has hedged its risk through its derivatives, and multiple subsequent counterparties have done the same. Creditors of the insolvent business that have material holdings of credit derivatives may have economic interests that potentially encourage them to cause a default to occur so that there is a credit event.[233] There are many factors that can affect the motivation and behaviour of stakeholders in an insolvency restructuring, given their economic interests; yet the creditor that has hedged its risk through a credit derivative is arguably in a different position in the restructuring proceeding, as there is a lack of transparency in respect of whether in fact there are economic interests at risk.[234] In turn, that may affect parties willingness to support a viable business plan.

In summary, there should be new measures in place to address the issue of transparency of economic interest in the insolvent business when creditors have hedged their risk through purchase of credit derivatives. There should be mandatory disclosure during a restructuring proceeding of the real economic risks at stake, including disclosure of the amount of debt that has been hedged by creditors that seek to exercise their voting or oversight rights in a restructuring proceeding. The court's consideration of any business proposal under the *BIA* should take account of economic interests at stake.

6. Debt to Asset Ratio

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[231] Sarra, *supra*, note 202. While arguably that managing of risk freed up capital for other market participants seeking to borrow, the previous reliance that creditors and other market participants often had on banks to engage in such monitoring and the resultant signalling of a firm's financial health, have diminished considerably.

[232] *Ibid.*

[233] This observation is not to lose sight of the fact that in a cash settlement, the protection buyer still has whatever it paid for the protection "at risk" in the insolvency proceeding.

[234] See Sarra, *supra*, note 202 for a list of recommendations to address these issues.

As discussed above, for the 200 file bankruptcy cohort, the median debt for corporations was 263,127 CAD while the median asset amount held was 8,322 CAD. For partnerships, the median amount of debt was 114,028 CAD, compared with 14,552 CAD in assets. For sole proprietorships, the median amount of debt was 99,799 CAD, compared with a median of 8,500 CAD of assets.

For proposals, a study of 200 representative business proposals indicates a slightly healthier debt to asset ratio under all three categories of business. For corporations filing proposals, the median debt was 98,115 CAD, compared with a median value of assets of 21,701 CAD. For partnerships, median debt was 61,218 CAD, compared with 28,800 CAD in assets. For sole proprietorships, the median debt was 65,800 CAD, compared with median assets of 18,950 CAD.

Clearly the higher value of assets is a driver for business debtors to file proposals. It is not simply the debt to asset ratio that determines potential outcome, but the type of debt, including interest rates, financing fees, control rights and restrictive covenants. There should be increased education on the benefits and risks of excessive leveraging and in how to make informed credit and risk decisions. In this respect lenders may also have some obligations in respect of advising potential borrowers of the nature and seriousness of the risks.

7. Linking Causes of Insolvency to Outcomes Sought through Business Proposals

One of the most challenging aspects of the study was to try to understand how the terms of proposals were aimed at addressing the underlying causes of the insolvency for the particular business. Based on the data that the OSB collects, it is almost impossible to discern how proposals address the causes. The study examined the terms of 200 proposals, in equal numbers from Division I and Division II. While the terms of compromise or arrangement are listed, there is little to link how the terms remedy the cause of the business debtor's insolvency.

This lack of transparency and linkage has two implications. First, it is unclear that creditors have a clear sense of how their compromise is going to address the underlying causes of the insolvency. Given that they must determine the amount of compromise that they are willing to agree to, whether as employees, operating lenders or trade creditors, creditors need to have a better understanding of whether the company should be liquidated in order to maximize firm value or whether there is merit in the proposed compromise or arrangement.

The study indicates that the most significant point of failure is creditor refusal to support the proposal. For all business proposals, 31% fail due to lack of creditor approval. Better transparency for creditors in terms of linking cause with outcome, may increase the willingness of creditors to support the proposal. Creditors often make their decision on the basis of whether the potential return to them under a proposal is better than it would be under liquidation. In many cases, creditors' primary reason for accepting the proposal is that they receive greater recovery than under a bankruptcy; and how that return is achieved or how or whether the debtor remedies the causes of its insolvency to achieve that higher payment does not seem to be a concern. It may be implicit in the proposal that if the debtor is offering more money than in a possible bankruptcy scenario, the debtor may be able to achieve a successful turnaround and overcome the problems leading it into insolvency; however, that conclusion is not evident based on the filings or judgments. If part of the rationale for creditors to agree to a proposal is it may preserve the credit relationship for the future, then being able to assess the

connection between the causes of insolvency and the proposal terms would enhance the potential for a credit relationship going forward.

The study identified a number of gaps in data collected by the OSB, identified throughout this report, particularly in Part II. Enhancement of data collection could serve to assist in making the links between cause of financial distress and strategy to remedy it. For example, in terms of causes of insolvency, the data could be collected in a "drop-down" electronic list that offers more detail in respect of causes, with space to report how the proposal addresses the particular cause.

However, Vern DaRe has posed the question of whether, by adding more mandatory terms to proposals, such as linking cause and remedy, the freedom of contract aspects of a proposal are being undermined.[235] He and his co-author John Honsberger suggest that except for mandatory terms, the terms of a proposal are limited only by the imagination of the drafters and "what will be acceptable to the creditors and the court".[236]

Such linkage may also have cost consequences, in terms of professional or transaction costs to prepare the proposal. One possible option would be to develop model proposal precedents, as some trustee or debtor counsel firms have already done, similar to model receivership orders, which could ensure parties make the linkage between cause of financial distress and outcome. Such models can control costs, and would have to be utilized in a manner that allows customizing of proposals, but creates a new baseline of directly addressing the cause of financial distress in the strategy adopted under the proposal.

As noted above, given the default structure of Division II creditor support, creditors are less likely to oppose a proposal, and given that the debt level will be raised affording more individual business debtors the opportunity to make a proposal under Division II, this amendment may reduce the number of failed proposals. Here too, however, there could be greater attention to how the terms of the proposal address the underlying causes of the insolvency.

When a proposal is before a registrar for approval, a key consideration is whether more dividends are paid to creditors under the proposal than would occur under a bankruptcy; and there was little evidence in the trustee survey to suggest that the issue of whether the debtor has remedied the causes of insolvency, except perhaps as it relates to s. 173 facts, is part of the registrar or court's consideration of whether to approve the proposal.

In terms of enhancing the success rate for proposals, the connection between the cause of financial distress and the proposal needs to be more transparent. 15% of Division I business proposals fail through default of terms of the proposal. If the sources and outcomes sought were better linked, it could possibly allow a reduction in defaulted proposals as the terms would be aimed at preventing the same cause of insolvency. 11.8% of proposals failed where they were Division II proposals and there was a default and deemed annulment. The high rate of failure at this point is likely due to the arbitrariness of the deemed failure provisions and limited opportunity to salvage a proposal once payments are missed. This problem is likely to be addressed with the amendments to the *BIA* that create a new system for reviving proposals.

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[235] John Honsberger and Vern DaRe, *Debt Restructuring: Principles and Practice* (Aurora: Canada Law Book, 2008), quoted with permission.
[236] *Ibid.*

Hence, the two most significant points of pressure, creditor approval and default on compliance with the terms both point to ensuring disclosures that are responsive to the need to link cause, proposal terms and expected outcome.

There is also an agency aspect to this issue. For sole proprietors, many partnerships and some small or medium sized incorporated businesses, the principal, in terms of direct economic stake in the business, is also the manager of the business. When the business is solvent, there is not an agency issue as the manger/owner is acting in his or her own interests in making decisions. However, at the point of insolvency, the creditors are arguably the residual claimants to the value of the business assets. There can be a conflict of interest therefore, in the manager's decisions regarding a proposed workout, which may be mitigated by the role of the proposal trustee or proposal administrator. Moreover, requiring a more transparent discussion of how the proposed terms of the proposal will address the underlying causes of the financial distress, may force managers to address these agency conflicts. For the corporation or partnership with a separation of ownership and control, transparency in linking cause of insolvency with proposal strategy also addresses agency issues that may arise from the managers seeking to preserve their own employment status post the workout.

As with governance and capitalization issues above, transparency is an important aspect of the linkage issue. Trustees and administrators advising business debtors on options need to have sufficient information to provide informed advice, and creditors require sufficient information to make informed decisions about whether to support a proposal or not. Yet aside from publicly traded companies, whose financial reporting is an ongoing requirement, for maintaining listings on a stock exchange and registration with securities regulators, the finances of the business, particularly for sole proprietors, can be a mess at time of filing. Business financies are often comingled with personal finances because personal credit cards have been used for the business. When the trustee reports its view of what likely recoveries are under a proposal versus a bankruptcy, the underlying assumptions or reasons are not always clear, and may be in part due to the lack of information that the trustee possesses as well. Debtors have an obligation to assist to the best of their ability. The difficulty is that the proposal trustee, administrator or bankruptcy trustee is the agent of creditors in making that assessment, given the information asymmetries and collective action problems faced by most creditors. It may be that there should be an enhanced obligation to provide insolvency professionals with accurate financial information that allows the professional to make that assessment properly. As noted above, unless the proposal trustees have more authority or the debtor has enhanced disclosure obligations, it may be difficult to achieve transparency and linkage in the proposal.

Yet, better identification of the causes of the insolvency for creditors, registrars and the courts would allow for more effective assessment of the proposal. Creditors may be more engaged and involved in the workout strategy if they can fully appreciate the source of financial distress such that the proposal strategy could have greater possibility of a recovery that promises more than just a marginal improvement over that available in bankruptcy.

Finally, it was evident that some proposals are a form of liquidating proposal. The trustees surveyed disagreed on the extent to which this practice occurs, likely because it is a more common practice in some regions, such as Québec and Ontario, than others.[237] Here again, there is a need for transparency as to why the

[237] In one study by Gosselin and Papillion, the majority of thirteen *BIA* proposal files studied used the proposal process for liquidation, *supra*, note 16 at 14.

proposal route is the fairest and more effective one for dealing with the insolvency rather than a traditional bankruptcy proceeding. While a discussion of the merits of liquidating proposals is beyond the scope of this study, it deserves further research attention.

The amendments to the *BIA* that facilitate the sale of an insolvent business to related persons are likely to enhance the transparency between the strategy chosen and the potential return to creditors. If the proposed sale or disposition is to a person related to the insolvent debtor, the court may grant the authorization only if it is satisfied that good faith efforts were made to sell or otherwise dispose of the assets to persons who are not related to the insolvent person; and the consideration to be received is superior to the consideration that would be received under any other offer made in accordance with the process leading to the proposed sale or disposition. A related person is defined to include a director, officer or person who has directly or indirectly controlled the debtor, and any person who is related to any of these people, again addressing some of the potential agency issues.

Generally, the study found that the highly codified *BIA* offers certainty and timeliness of the proposal process, and can be more cost effective for business debtors to restructure their business. The availability of DIP financing for proposal proceedings has been a major new advantage in choice of restructuring proceeding, although to date, it has not been frequently used. Its use is likely to increase substantially when the provisions are codified with the amendments to the *BIA,* and may offer an opportunity for DIP lenders to require a clear link between the cause of insolvency and the DIP financing for the restructured business, given the criteria that the court is to consider in granting requests.

In summary, there is a need to link business proposals more directly to the source of distress, including governance, market and other factors, both to encourage a higher degree of creditor confidence in the proposed strategy and to help ensure that the outcome of the proposal truly addresses as many of the causes as possible.

8. Significance of Proposed Amendments to Proposal Provisions

Part II above discussed the legislative framework, including proposed amendments to the proposal provisions of the *BIA*. Given the analysis of when and why proposals fail, it is important to briefly comment on the significance of the amendments to the failure rate.

The proposed amendment to the definition of debtor for purposes of access to Division II proposals will increase the amount of debts that an individual may have to be eligible to make a Division II proposal from 75,000 CAD to $250,000 CAD. The previous indebtedness ceiling of 75,000 CAD became too low and forced many self-employed individuals and higher-income debtors to make a more costly and more complicated Division I proposal, in turn, reducing recovery for creditors. In addition, failure of a Division I proposal results in an automatic bankruptcy, whereas failure of a Division II proposal does not. The increase in the indebtedness ceiling was aimed at making the simpler and more cost-effective consumer proposal scheme available to a greater number of people and thus should encourage more proposals. It will allow access for individuals, including non-incorporated sole proprietors and partners, to the simplified and more cost-effective proceedings.

The proposed amendments should also assist with the failure rate of proposals. As discussed above, the second greatest number of proposals fail when they are deemed annulled after some period of making payments under the proposal.

Under the new amendments, there is a new procedure to be able to revive a deemed annulled proposal. The provisions provide the administrator with the discretion to revive a consumer proposal that has been deemed annulled. Previously, there was no way to revive a consumer proposal that was in default.[238] The new section allows an administrator to rectify the default by providing notice to the creditors. It assists in situations where the debtor faces a temporary problem meeting payments, for example, due to illness or temporary unemployment, but otherwise is making good faith efforts to comply with the terms of the proposal. Creditors have the opportunity to object to the revival. The creditors' rights to the amount of their claims less any dividends received are revived between the day on which the proposal is deemed to be annulled and the day on which it is revived, a period of 45 days.

In the case of a deemed annulment of a Division II proposal made by a person other than a bankrupt, if the administrator considers it appropriate to do so in the circumstances, it may, with notice to the official receiver, send to the creditors, within 30 days after the day on which the consumer proposal was deemed annulled,[239] a notice informing them that the consumer proposal will be automatically revived after 60 days,[240] unless a creditor files with the administrator a notice of objection to the revival. If no notice of objection is filed within the time period, the proposal is automatically revived on the expiry of that period. If a notice of objection is filed, the administrator is to send to the official receiver and to each creditor a notice informing them that the proposal is not going to be automatically revived on the expiry of that period. The administrator may also apply to the court, with notice to the official receiver and the creditors, for an order reviving any Division II proposal of a debtor who is not a bankrupt that was deemed to be annulled, and the court, if it considers it appropriate to do so in the circumstances, may make an order reviving the proposal, on any terms that the court considers appropriate.[241]

The revival provisions should make a significant improvement in the current failure rate of proposals, as it allows the administrator, and in some instances the court, to relieve against unforeseen obstacles that temporarily hindered the debtor's ability to meet the conditions of the proposal.

9. Conclusion

In summary, two of three working hypotheses were borne out by the data. There are multiple causes of business failure, some of which are related to the experience and skills of the principals of the business and some of which are related to more general economic conditions that are beyond the control of individual directors and officers. For those causes that relate to the skills of principals of the business, there are strategies that should be considered to

[238] Some registers and judges in Ontario used very creative ways of not deeming a proposal to be in default, but the statute itself did not offer a remedy.
[239] Proposed section 66.31(6), 30 days or any other number of days that is prescribed.
[240] Or any other number of days that is prescribed, after the day on which it was deemed to be annulled.
[241] Pursuant to proposed s. 66.31(9).

enhance the governance, financial management and strategic planning of those businesses before they become financially distressed.

A second working hypothesis was that the nature of debt may be changing, such that businesses are facing greater challenges than previously in their credit relationships. This hypothesis was borne out in the increase in credit card debt, particularly among sole proprietors, and in the higher degree of leveraging that appears to be occurring now, particularly for incorporated entities, creating new levels of risk for creditors. It is also evident in the uncoupling of credit risk and oversight by traditional operating lenders because of credit derivatives.

The third working hypothesis was that the reported rate of proposal failure may not be entirely reflective of the efficacy of statutory proposal provisions, even eliminating those notices of intention to make a proposal that fail immediately as they only intended to give the debtor a few days breathing space to stay creditors until they consider their options. In fact, for the data examined, the greatest failure occurs at the creditor approval stage and then at a point of default during the proposal payment period, not at point of filing. The above recommendations, linking causes of insolvency with the terms of proposals, are aimed at reducing the failure rates at those points in the process.

Another theme that is reflected throughout the study is that the role of OSB could be more preventive and socially implicated rather than focusing solely on the regulatory aspects of its mandate, particularly in working with lending institutions and debtors to adopt more responsible governance and lending practices. An insolvency system requires the confidence of the public in order to operate effectively; yet where the workout mechanism does not address the reasons for the business insolvency, public confidence can be undermined, in turn having implications for the effectiveness of proposals as a means of preserving economic activity.

Insolvency policy is best designed based on solid empirical evidence. In the area of business insolvency, there continues to be a lack of data that can inform policy making, and this study offers initial steps in beginning to build a systematic source of information. If the remaining reforms contained in Statutes of Canada Chapter 36 are proclaimed into force, the data could provide a baseline of data on which to gage the effectiveness of the amendments, in areas such as the enhanced disclosure reporting requirements. In this respect, the OSB should be collaborating with scholars and insolvency professionals to identify key issues and data points that should be tracked. Trustees use their professional judgment every day in advising how firms and individuals can address commercial financial distress. A better understanding of the causes of commercial insolvency, and some of the practical differences between insolvency for sole proprietorships, partnerships, and corporations of various sizes may allow trustees in the field to better advise debtors in respect of their options for resolution of the financial distress.

As noted in the introduction, the founding and operation of a business, whether a sole proprietorship, partnership, or incorporated business, is a grab at the brass ring, in the sense of resources deployed, governance skills, business acumen, cogent business plan, ability to raise capital, market timing, and overall economic climate. This study has assisted in identifying how to improve that grab, in the sense of strategies in respect of governance and financing. It suggests the need for enhanced disclosure to creditors and information to better alert debtors to the most significant systemic risks, such that more realistic choices are made early in the decision process, in turn, enhancing insolvency outcomes.