



BANKRUPTCY: PROTECTING UNPAID SUPPLIERS

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Revised 14 November 2008

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INTRODUCTION

The notion of providing some type of protection to unpaid suppliers of goods when a purchaser goes bankrupt is not new to Canadian law. Unpaid suppliers were first granted protection, in the form of a right to repossess their goods, with the enactment of section 81.1 of the *Bankruptcy and Insolvency Act* (BIA) in 1992.⁽¹⁾ This right was intended to prevent suppliers from being taken advantage of by insolvent debtors who ordered excessive amounts of inventory shortly before bankruptcy in order to increase the assets available to satisfy secured creditors – a practice known as “juicing the trades.”

The unpaid suppliers’ right of repossession, also called the “30-day goods rule” because the right applies to goods delivered within 30 days prior to a purchaser’s bankruptcy, has been the subject of considerable debate. This debate focuses on both the right’s effectiveness and whether it should exist in the first place.

At the same time as unpaid suppliers of goods were granted a right of repossession, farmers, fishers and aquaculturists were also granted bankruptcy rights – a charge on the inventory of the purchaser – in relation to products for which they had not received full payment. Enacted as section 81.2 of the BIA, this right differs substantially from the repossession right granted to unpaid suppliers under section 81.1.

This paper provides an overview of sections 81.1 and 81.2 of the *Bankruptcy and Insolvency Act*.

* The original version of this document was prepared by Margaret Smith, formerly of the Library of Parliament.

(1) R.S.C. 1985, c. B-3, as amended.

SECTION 81.1 OF THE *BANKRUPTCY AND INSOLVENCY ACT* – PROTECTION FOR UNPAID SUPPLIERS OF GOODS

Section 81.1 of the BIA gives unpaid suppliers a right to repossess goods sold and delivered to a purchaser who becomes bankrupt or who has been placed in receivership.

In order for the right to be operative and the goods eligible for repossession, the criteria set out in subsection 81.1(1) must be followed.

- First, the supplier has to make a written demand for the goods within 30 days after delivery to the purchaser.
- Second, the purchaser has to be bankrupt or in receivership at the time the demand is made.
- Third, the goods must be used in relation to the purchaser's business and in the possession of the receiver, trustee or purchaser.
- Fourth, the goods must be identifiable and not fully paid for, in the same state as they were on delivery, and not resold at arm's length or subject to an agreement for sale.

The right to repossess the goods expires if not exercised within 10 days after the trustee, receiver or purchaser has confirmed it.

Where the goods have been partly paid for, a supplier has the right to repossess a portion of them, proportional to the amount owing, or to repossess all the goods after repaying the amount of any partial payment previously received.

The supplier's right to repossession ranks ahead of any other claim in respect of those goods, other than a claim by a *bona fide* purchaser for value without notice of the repossession request.

SECTION 81.2 OF THE *BANKRUPTCY AND INSOLVENCY ACT* – PROTECTION FOR UNPAID FARMERS, AQUACULTURISTS AND FISHERS

Section 81.2 of the BIA establishes a special right for farmers, fishers and aquaculturists who deliver their farm and fisheries products to a purchaser for use in the purchaser's business. Where the purchaser subsequently becomes bankrupt or is placed in receivership and such products are delivered within 15 days prior to the purchaser's bankruptcy or receivership, the farmer, fisher or aquaculturist can file a claim for any unpaid amount in

respect of those products within 30 days after the bankruptcy or receivership. This claim is secured by a charge on all the inventory held by the purchaser; it takes priority over all other rights or charges against that inventory, except an unpaid supplier's right of repossession.

If the trustee or receiver subsequently disposes of the goods in question, the charge extends to the proceeds of sale less realization costs.

CRITICISMS OF SECTION 81.1

When section 81.1 was introduced, it was greeted with a certain degree of scepticism. Some 10 years later, reviews are still mixed. While suppliers support the concept of protecting trade creditors, many complain that the current regime is ineffective and inefficient. In other words, critics claim that section 81.1 does not afford the protection it was intended to provide.

The time frames within which unpaid suppliers must act to preserve their repossession right are particularly problematic. The main problem is that the event that triggers repossession – the date of the purchaser's bankruptcy – is not germane to establishing the beginning or the end of the 30-day time period.

The following example illustrates the problem:

- Assume that a supplier delivers goods to a purchaser on 1 August 2008 and the purchaser goes bankrupt on 28 August 2008. According to the *Bankruptcy and Insolvency Act*, a bankruptcy trustee has five days after the date of a bankruptcy within which to notify creditors of the bankruptcy. (Receivers, on the other hand, must give notice of a receivership within 10 days following the date of the receivership.)
- The trustee notifies the unpaid supplier of the purchaser's bankruptcy on 1 September 2008.
- The supplier presents a demand to repossess his or her goods on 2 September 2008 – 32 days after the goods were delivered.

Under this scenario, the unpaid supplier loses his or her repossession right. Because section 81.1 provides that the supplier must deliver a written demand to repossess his or her goods within 30 days after delivery of the goods to the purchaser and the purchaser must be bankrupt at the time the demand is made, when a purchaser goes bankrupt near the end of the 30-day delivery period, it is often difficult, if not impossible, for a supplier to receive notice of the bankruptcy and thus deliver a repossession demand before the 30-day period expires.

Another problem area is the requirement that the goods be in the same state as they were on delivery. If the goods are transformed through a production process, the right will be lost.

Professor Ronald Cuming of the University of Saskatchewan describes the protection offered by section 81.1 as arbitrary. He states:

A problem endemic to the approach contained in section 81.1 is the arbitrariness of its protection. If the goods have been sold prior to the unpaid seller making a claim for their return, not only is there no right of recovery, but the unpaid seller has no substitute remedy. This is so even though it is possible through identification or tracing to show that the proceeds of the sale are being held by the trustee or receiver. If the goods are not in the same state as they were on delivery the right of recovery is lost even though the goods in their altered form are in the possession or control of the trustee or receiver. Further, the availability of the remedy is conditioned by factors beyond the control of the supplier. Indeed, the buyer, a secured party, a trustee or a receiver is placed in the position of being able to preclude a seller's right of recovery by acting quickly to alter or dispose of the goods before the supplier is able to claim repossession.⁽²⁾

Furthermore, there are evident gaps in the protection afforded by section 81.1. Those who provide services rather than goods have no protection. Moreover, there is no real protection in reorganization proceedings under either the BIA or the *Companies' Creditors Arrangement Act* (CCAA).

CRITICISMS OF SECTION 81.2

Interestingly, there has not been a great deal of criticism of section 81.2. It is generally accepted that the section is less complicated than its section 81.1 counterpart.

Nevertheless, Professor Ronald Cuming has identified "three serious deficiencies"⁽³⁾ in the section. These are:

- the narrow range of goods and limited time frame in relation to which the charge operates;

(2) Ronald C. C. Cuming, *Priority for Unpaid Suppliers of Goods and Services in Bankruptcy, Insolvency, Winding-up and Receivership Proceedings*, Background Paper prepared for Industry Canada, June 1998, p. 4.

(3) *Ibid.*, p. 6.

- the limited scope of the charge – it applies to inventory only; and
- the inapplicability of the remedy in reorganization proceedings under the BIA or the CCAA.⁽⁴⁾

RECENT DEVELOPMENTS

In anticipation of a statutory five-year review of the BIA, Industry Canada held consultations on the Act in 2002. Protection for unpaid suppliers proved to be one of the most contentious issues emerging from these consultations.⁽⁵⁾

Suppliers pointed to difficulties in applying section 81.1. Their concerns related to both the application of the section and its narrow judicial interpretation, notably in relation to the requirement that goods be in the same state as they were when first sold. In this regard, suppliers called for the BIA to be more explicit in order to give greater guidance to the courts.⁽⁶⁾

Suppliers supported amending the timing provisions in order to allow more time after a purchaser's bankruptcy to repossess goods delivered 30 days prior to the bankruptcy.⁽⁷⁾ This proposal would make the date of the bankruptcy the event that demarcates the 30-day delivery period and the period within which the repossession demand must be made.

Suppliers also proposed that they be offered a first right option to purchase the goods back from a bankrupt purchaser. Such a proposal, they noted, could improve recovery for all creditors, and give suppliers an opportunity to recover full value of the goods by reselling them to another person.⁽⁸⁾

The impact of reorganization proceedings on unpaid suppliers' rights raised concerns, as well.⁽⁹⁾ For example, the stay of proceedings, which takes effect upon the filing of a notice of intention to reorganize under the BIA, does not give unpaid suppliers the right to

(4) Ibid.

(5) Industry Canada, *Report on the Operation and Administration of the "Bankruptcy and Insolvency Act" and the "Companies' Creditors Arrangement Act,"* September 2002, [http://strategis.ic.gc.ca/epic/internet/incilp-pdci.nsf/vwapj/3040-Bankruptcies.pdf/\\$FILE/3040-Bankruptcies.pdf](http://strategis.ic.gc.ca/epic/internet/incilp-pdci.nsf/vwapj/3040-Bankruptcies.pdf/$FILE/3040-Bankruptcies.pdf).

(6) Ibid., p. 33.

(7) Ibid., p. 34.

(8) Ibid.

(9) Ibid.

repossess unpaid goods delivered to a debtor business. In this situation, debtors have been known to liquidate assets during the stay period and pay other creditors from the proceeds of sale.

Remedies proposed to address the problems with section 81.1 included:

- amending the BIA to provide better protection to unpaid suppliers in reorganizations;
- automatically segregating and accounting for all unpaid goods, with the proceeds of sale placed in trust for the benefit of unpaid suppliers, and making directors personally liable when debtors fail to comply;⁽¹⁰⁾
- precluding secured creditors from obtaining security on any goods delivered within 90 days prior to a bankruptcy;⁽¹¹⁾
- allowing unpaid suppliers to have a deemed security interest;⁽¹²⁾ and
- providing suppliers with some form of protection under a notice of intention or proposal, and reaffirming their rights if the proposal is rejected by creditors or by the court.⁽¹³⁾

Other critics of the current regime, notably insolvency lawyers and trustees, were opposed to enhancing suppliers' rights, arguing that the ability to obtain security through contract is sufficient.⁽¹⁴⁾

Insolvency professionals further contended that the right was infrequently used, in part because its effectiveness had been diminished through court interpretations.⁽¹⁵⁾

In his analysis of unpaid suppliers' rights, Professor Cuming concludes that the right of recovery should not be dependent "upon the types of goods involved or what happens to the goods once they are delivered."⁽¹⁶⁾ He prefers the conceptual approach embodied in

(10) Industry Canada, Office of the Superintendent of Bankruptcy, *National Insolvency Forum: Montreal Regional Report*, 1999, pp. 11–12; available online at <http://dsp-psd.pwgsc.gc.ca/Collection/RG64-10-2000-3E.pdf>.

(11) Industry Canada, Office of the Superintendent of Bankruptcy, *National Insolvency Forum: Saskatoon Regional Report*, 1999, p. 12; available online at <http://dsp-psd.pwgsc.gc.ca/Collection/RG64-10-2000-5E.pdf>.

(12) Industry Canada, Office of the Superintendent of Bankruptcy, *National Insolvency Forum: Vancouver Regional Report*, 1999, p. 11; available online at <http://dsp-psd.pwgsc.gc.ca/Collection/RG64-10-2000-6E.pdf>.

(13) Ibid.

(14) DEL Industry Canada (2002), p. 34.

(15) Ibid.

(16) Cuming (1998), p. 32.

section 81.2⁽¹⁷⁾ that creates a first charge on the purchaser's assets and employs less onerous timing constraints. Professor Cuming recommends that the BIA be amended to provide a limited special charge for claims for amounts owing to unpaid suppliers of goods and services. This charge would have priority over security interests, certain liens, and other charges but not over unpaid wage claims, purchase money security interests or certain other liens.⁽¹⁸⁾ Details of the administration and operation of Professor Cuming's proposed charge are set out in a background paper prepared for Industry Canada, *Priority for Unpaid Suppliers of Goods and Services in Bankruptcy, Insolvency, Winding-up and Receivership Proceedings*.

The Senate Standing Committee on Banking, Trade and Commerce conducted a periodic review of the BIA in 2003, and heard testimony from a variety of groups, some in favour of, and others opposed to the unpaid supplier protections. Among the problems noted with the provisions were these:

- no requirement that suppliers be notified of a bankruptcy in time to make a claim within the required 30-day period;
- the limitation of protection to suppliers of goods, excluding suppliers of services and credit;
- the reduction in the value of an estate when other creditors make their claims within the 30-day period of protection monitoring and administration;
- the extra-contractual protection provided to suppliers that was not originally negotiated between the parties to the contract;
- the other legal remedies open to suppliers to protect their interests under regular contract law; and
- the incentive for lax credit practices between suppliers and their clients.⁽¹⁹⁾

Some testimony, from groups such as private lawyers and the Canadian Bankers Association, described unpaid suppliers as a "special interest group" and suggested that there was no policy justification for providing them with protection.⁽²⁰⁾ On the other hand, the

(17) Ibid.

(18) Ibid., p. 35.

(19) Standing Senate Committee on Banking, Trade and Commerce, *Debtors and Creditors Sharing the Burden: A Review of the "Bankruptcy and Insolvency Act" and the "Companies' Creditors Arrangement Act,"* November 2003, pp. 106–107.

(20) Ibid., pp. 107–108.

Canadian Federation of Independent Business explained the practical difficulties that render the 30-day period of little use without notice of the bankruptcy. The Federation also noted that the protection only applies to unmodified goods, and just opening a box of supplies could be seen as altering them under the legislation. The Federation was particularly concerned about the problem of “juicing the trades,” and further, about companies declaring bankruptcy under one name, and then continuing business under another using the old supplies without being liable for payment.⁽²¹⁾

Solutions proposed to the Senate Committee included:

- the extension of the repossession right beyond 30 days;
- preventing ownership of the goods from passing to the debtor until the supplier is paid in full;
- the representation of unpaid suppliers on a creditors’ committee that would help oversee the bankruptcy process;
- placing the debtor at arm’s length from the disposal of assets;
- the introduction of more severe penalties for asset rollovers; and
- converting the unpaid suppliers’ right to a lien once bankruptcy is declared.⁽²²⁾

The Writers’ Union testified before the Senate Committee, presenting the view that it should be added to the legislation in a manner similar to that of fishers, farmers and aquaculturists. The Union argued that authors and content creators should have a lien on any works resting with the debtor that have not yet been fully paid for at the time of a bankruptcy.⁽²³⁾

The Senate Committee concluded from the testimony that it was clear that section 81.1 was not working as intended. The Committee’s final recommendation was that rather than being amended, the provision should be removed from the BIA altogether, with only the special rights for farmers, fishers, and aquaculturists preserved.⁽²⁴⁾

Despite this recommendation, the provisions were not excised from the BIA, and have only been amended for minor technical clarifications of their wording. In fact, in the years

(21) Ibid., pp. 108–109.

(22) Ibid., pp. 109–110.

(23) Ibid., p. 110.

(24) Ibid., p. 110–111.

following the Senate Committee's review, the legislative trend has been in the opposite direction – special protections for certain amounts of unpaid wages and pensions have been added as the new sections 81.3 to 81.6 of the BIA that came into effect in July 2008.

Sections 81.3 and 81.4 secure the claims of employees and salespeople who are owed wages, salaries, commissions or compensation in the time leading up to a company's bankruptcy or receivership. Sections 81.5 and 81.6 secure contributions made by employees both to pension plans regulated by federal legislation and to pension plans administered by the company.

These amendments were added in two stages. Sections 81.3 to 81.6 were originally added to the BIA through the expedited passage of a bill in 2005 prior to an imminent election. These new sections were not proclaimed in force because the Senate Committee had not finished hearing witnesses on the changes. Once a new government came into power in 2006, the wording of sections 81.3, 81.4 and 81.6 was further refined to clarify their application, although the basic concepts were not substantially changed. This second set of amendments was introduced in 2006, but various procedural and other hurdles arose, and they were not passed until late 2007, when the Senate Committee was able to review what had essentially become the amendments to the amendments. Owing to the long delay in finalizing the legislation, the Senate agreed to move it forward. It was proclaimed in force in 2008, although the Senate Committee has expressed an intention to continue to study the new amendments and their effects.⁽²⁵⁾

The changes are too new to have been the subject of extensive criticism thus far. The amendments create more protections for creditors who would not otherwise have security, placing them in line for repayment behind the unpaid suppliers described in sections 81.1 and 81.2 and before secured creditors, and pushing the secured creditors further down the list of those to be repaid from existing assets.⁽²⁶⁾

(25) Marcia Jones, *Bill C-12: An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and Chapter 47 of the Statutes of Canada, 2005*, LS-584E, Parliamentary Information and Research Service, Library of Parliament, 14 December 2007, <http://www.parl.gc.ca/LEGISINFO/index.asp?List=ls&Query=5298&Session=15&Language=e>.

(26) Ibid.

CONCLUSION

Protecting unpaid suppliers of goods in bankruptcy proceedings has been a contentious area of bankruptcy law since the repossession right was enacted in 1992. After more than 15 years of operation, it is no less controversial. Singling out a particular group of creditors for enhanced protection involves trade-offs and policy choices that often pit various types of creditors against one another, and the expansion of the groups protected under recent amendments to the BIA may exacerbate this problem. In the case of unpaid suppliers' rights, the two main antagonists are typically suppliers, who want to reduce the adverse affects of a bankruptcy on their ability to recover monies owing for goods supplied, and credit-granting organizations that see the value of their claims diminished by repossession rights. The latter now have even more competitors for those claims.

Views about the present regime are as varied as they are strong. Suppliers argue that section 81.1 is necessary and should be improved. Others, arguing that the current regime is ineffective and burdensome, believe that unpaid suppliers should have no special protection under the BIA. Regardless of the position taken, few, if any, appear to be content with the status quo.