Unpaid Suppliers' Rights and Liquidating *CCAA*s: The need to Reform Section 81.1

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I. <u>Introduction</u>

Suppliers of goods enjoy certain priority rights in bankruptcy and receivership that are not similarly extended to restructuring proceedings. The non-application of suppliers' rights to restructuring proceedings was a rational public policy decision premised on the traditional concept of a restructuring. Allowing suppliers to have special rights in a restructuring would hinder the debtor company's ability to emerge from the process as a going concern and could lead to the socially undesirable consequences that result from a liquidation. However, the use of the *Companies' Creditors Arrangement Act*[1] (*CCAA*) has changed radically from its original purpose. Now, many proceedings under the *CCAA* are initiated for the sole purpose of liquidating a company's assets leaving no going concern entity in its place.

This paper argues that the absence of suppliers' rights from the *CCAA* is defeating the purpose and intent of those rights as they exist under the *Bankruptcy and Insolvency Act*[2] (*BIA*). Parliament has clearly indicated that, for policy reasons, suppliers are to receive special treatment when a debtor is being liquidated through bankruptcy or receivership. To maintain the status quo is to invite regime shopping by both creditors and debtors to suit their individual needs. The choice of regime should be one based upon value maximization for the debtor company and its stakeholders and should not be subject to self-interested motivations that benefit some creditors to the detriment of others.

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[1] *Companies' Creditors Arrangement Act,* RSC 1985 c C-36 [*CCAA*].

[2] *Bankruptcy and Insolvency Act,* RSC 1985, c B-3 [*BIA*].

II. Section 81.1

The 1992 amendments to the *BIA* brought into force new rights for suppliers in the form of s. 81.1.[3] Section 81.1, or the "thirty-day goods" provision, allows unpaid suppliers to repossess goods supplied within thirty days of the company's bankruptcy or receivership if the provision's technical requirements are met.[4]

The thirty-day goods provision was introduced to address the vulnerability of suppliers. Suppliers find themselves in a power imbalance with their often larger, more sophisticated, trading partners.[5] Therefore, suppliers do not have the bargaining power to demand security for the goods they supply. However, this ground for justifying suppliers' rights has been discredited because it fails to distinguish suppliers of goods from suppliers of services or other unsecured creditors who find themselves in a power imbalance with a larger debtor and do not enjoy a similar priority.[6]

Further, and more convincingly, s. 81.1 exists to prevent abuse of the trade relationship by the debtor company. A debtor may order goods immediately before commencing insolvency proceedings to enrich its asset base for the benefit of its secured

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[3] *Ibid* at s 81.1. Section 81.2 was enacted at the same time as 81.1. Section 81.2 grants a priority charge over all of the debtor company's inventory in favour of unpaid farmers, fishers and aquacultural suppliers commensurate with the amount supplied within fifteen days of the bankruptcy or receivership.

[4] *BIA*, *supra* note 2 s 81.1. The technical requirements are explained in Roderick J Wood, *Bankruptcy & Insolvency Law* (Toronto: Irwin Law, 2009) at 132 [Wood, *Bankruptcy*]:

1. Written demand for repossession must be given within fifteen days after the debtor enters bankruptcy or receivership;
2. Goods must have been delivered to the debtor company within thirty days of the bankruptcy or receivership;
3. Debtor company must be bankrupt or a receiver has been appointed; and
4. Goods must be in the possession of the debtor, the trustee, or the receiver and must be identifiable as the goods delivered. They must not have been subsequently sold or promised to be sold in an arm's length transaction.

[5] Senate, 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) (Chair: Hon. Richard H. Kroft) at 106 [Senate Report].

[6] Tamara Buckwold & Roderick J Wood, "Priorities" in Stephanie Ben-Ishai & Anthony Duggan, eds, *Canadian Bankruptcy and Insolvency Law: Bill C-55, Statute c. 47 and Beyond* (Toronto: LexisNexis Canada Inc, 2007) at 121 [Buckwold & Wood].

creditors. Where the enrichment occurs due to abuse, it has been referred to as "juicing the trades"[7] or "bulking up".[8] Preventing the unfair enrichment of the debtor asset base has been described as the "only...convincing policy basis for the priority."[9]

III. Liquidating *CCAAs* and Suppliers' Rights

The original purpose of the *CCAA* was "to facilitate the making of a compromise or arrangement between an insolvent debtor company and its creditors to the end that the company is able to continue in business."[10] The protection offered by the *CCAA* stay of proceedings prevents the company's creditors from acting on their security or initiating proceedings against it while a compromise is negotiated. Logically then, the whole "process is geared towards the development of a plan of arrangement that will be presented before the creditors for their acceptance or rejection."[11] The statute's purpose has also been stated as permitting "the debtor to continue to carry on business and, where possible, avoid the social and economic costs of liquidating its assets."[12] As a going concern, the restructured company is typically of more value to stakeholders than if it had been liquidated.

The *CCAA* was not enacted with the intended purpose of liquidating companies.[13] Despite this, the use of the *CCAA* as a vehicle for liquidation has become commonplace over the last ten to fifteen years. For example, between 2002 and 2012, approximately

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[7] Senate Report, *supra* note 5.
[8] *Agro Pacific Industries Ltd., Re,* 2000 BCSC 837 at 37, 97 ACWS (3d) 383 [*Agro Pacific*].
[9] Buckwold & Wood, *supra* note 6. The Senate Report, *supra* note 6 also suggested that suppliers will be more likely to continue supplying a debtor company as it faces financial difficulties knowing it has the right of repossession. This has been criticized as being of minimal reassurance to suppliers especially considering that the right does not extend to restructuring proceedings. See Wood, *Bankruptcy*, *supra* note 5 at 133.
[10] *Hongkong Bank of Canada v Chef Ready Foods ltd.,* [1991] 2 WWR 136 at 10, 23 ACWS (3d) 976.
[11] Roderick J Wood, "Rescue and Liquidation in Restructuring Law" (2013) 53 Can Bus LJ 407 at 410 [Wood, "Rescue and Liquidation"].
[12] *Ted Leroy Trucking [Century Services] Ltd., Re,* 2010 SCC 60 at 47, 3 SCR 379 [*Century Services*].
[13] Alfonso Nocilla, "The History of the Companies' Creditors Arrangement Act and the Future of Re-Structuring Law in Canada" (2014) 55 Can Bus LJ 73 at 87 [Nocilla, "History"].

one-third of all *CCAA* proceedings were used for liquidation purposes.[14] This paper does not explore the merits of *CCAA* liquidations. However, the appropriateness of using the statute for this purpose has been the subject of considerable commentary.[15]

Where priorities differ amongst regimes, the results can be detrimental to the integrity of Canada's insolvency system. Deschamps J., in *Century Services,* stated that such priority differences may encourage "statute shopping" by creditors.[16] Without recognition of suppliers' rights under the *CCAA*, secured creditors, and the debtor company, can benefit by electing to liquidate through the *CCAA* as opposed to bankruptcy or a receivership at the expense of suppliers.

The use of the term "liquidation" can cause conceptual problems. Karma Dolkar has differentiated between a "liquidation" and a "liquidating plan."[17] A "liquidation occurs when assets are sold on a piecemeal basis" while a "liquidating plan occurs when the assets of the debtor company are sold on a going concern basis to a willing buyer."[18] Liquidating plans can be further broken down into two subcategories: where there is a sale of assets in an operational state or an idled state which allows for their mobilization with minimal investment and sale of a block of assets that could be rendered operational by additional investment.[19] A clear difference between liquidations and liquidating plans is that under the latter, there is preservation of going concern value.[20] Where there is a going concern, "the business survives and the web of relationships that relate to the

[14] Alfonso Nocilla, "Is 'Corporate Rescue' Working in Canada?" (2013) 53 Can Bus LJ 382 at 387-392 [Nocilla, "'Corporate Rescue'"].
[15] Wood, "Rescue and Liquidation", *supra* note 11; Nocilla, "History", *supra* note 13.
[16] *Century Services*, supra note 12.
[17] Karma Dolkar, "Re-Thinking Rescue: A Critical Examination of CCAA Liquidating Plans" (2011) 27 BFLR 111.
[18] Bill Kaplan, "Liquidating CCAA: Judicial Discretion Gone Awry?" in Janis Sarra, ed., Annual Review of Insolvency Law (Toronto: Thomson Carswell, 2008) at 92 cited in Dolkar, *supra* note 18 at 114-115.
[19] Kaplan, *supra* note 18.
[20] Dolkar, *supra* note 17 at 115.

business can be continued."[21] Socially, and economically, preservation of going concern value is usually more desirable than liquidation.

When the *CCAA* is used as a vehicle for liquidation, the rationale for withholding suppliers' rights from the *CCAA* hits a conceptual stumbling point. Where there is no going concern value to diminish, suppliers should be allowed to exercise their rights as Parliament intended in a liquidation proceeding. Furthermore, unless it can be shown that liquidations under the *CCAA* result in higher returns to stakeholders generally, then the statute's use for liquidation purposes skews the distribution of assets in favour of certain creditors without benefiting the whole. It has been noted that the "proponents of liquidating CCAAs have produced no evidence to support the assertion that liquidating CCAAs are more efficient or more likely to maximize returns for creditors generally than bankruptcy or receivership sales."[22]

Selection of the *CCAA* for liquidation may be due to other benefits afforded by the statute. Most notable among these is the *CCAA*s inherent flexibility. However, extension of suppliers' rights to the *CCAA* would not detract from such flexibility. Also, flexibility in this context involves a "diminution of the private law rights of a third party or the granting of a judicially authorized preference usually in favour of commercially sophisticated and powerful creditors."[23] This aptly describes the benefit that accrues to secured parties at the expense of suppliers through a liquidating *CCAA*.

IV. **Judicial Commentary**

Judicial commentary concerning suppliers' rights in restructurings is scarce. However, there appears to be some reluctance on the part of the judiciary to accept the denial of

[21] Kaplan, *supra* note 18 at 88.
[22] Nocilla, "History", *supra* note 13 at 95.
[23] Wood, "Rescue and Liquidation", *supra* note 11 at 413.

suppliers' rights in liquidation proceedings. In *Woodward's Ltd., (Re),* Tysoe J. stated that allowing suppliers to repossess their goods in a restructuring would not only contravene the express wording of s. 81.1 but "would be counter-productive to the company's reorganization effort because it would deprive the company of assets it requires to continue carrying on business and to make a viable reorganization proposal."[24] However, Tysoe J. noted the potential for abuse where priorities differed across insolvency regimes indicating that "[i]nsolvent companies would attempt to defeat the potential rights of suppliers by utilizing the *CCAA* and the protection given to suppliers by s. 81.1 would become illusory."[25]

In the restructuring of another large retailer, *T. Eaton Co., (Re),*[26] Farley J. commented on the submission of counsel, who was seeking the termination of the thirty-day period within which Eaton Co. could file a proposal,[27] that Eaton Co. was not restructuring but was attempting a straight piecemeal liquidation. Farley J. recognized that such an observation may be particularly noteworthy concerning prospective amendment of the *BIA*, but did not elaborate further as he did not believe the situation to be one of straight liquidation.[28] In another decision of Farley J., he stated that "unpaid supplier rights are truly intended to protect against the unfair consequences in liquidation as seen by Parliament and are not intended to affect or disrupt reorganizations…"[29]

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[24] *Woodward's Ltd., (Re),* [1993] 100 DLR (4th) 133 at 24, 37 ACWS (3d) 1041 [*Woodward's #1*].
[25] *Woodward's Ltd., (Re)*, [1993] 100 DLR (4th) 146 at 8, 17 CBR (3d) 253 [*Woodward's #2*].
[26] *T Eaton Co., Re*, [1999] 12 CBR (4th) 130, 90 ACWS (3d) 960 [*Eaton Co*].
[27] Under s. 50.4(1) *BIA* a debtor company can file a Notice of Intention (NOI) to file a proposal giving it thirty days to do so while creditors are stayed. A creditor may apply to terminate the thirty-day period pursuant to s. 50.4(11) *BIA* if any of subsections (a) through (d) are proven.
[28] *Eaton Co, supra* note 26 at 16.
[29] *Bruce Agra Foods Inc. v Proposal of Everfresh Beverages Inc. (Receiver of)*, [1996] 45 CBR (3d) 169 at 6, 68 ACWS (3d) 399.

In the more recent decision of *Puratone Corp., (Re)*,[30] suppliers of grain applied to lift the stay of proceedings to sue the company and its directors based on allegations that Puratone continued to order grain when it was aware that it would be filing under the *CCAA*. Dewar J. acknowledged that "[t]he [suppliers] raise a point which so far as I am aware has not been addressed by this court…the court is faced with a CCAA proceeding which has had from the outset all of the earmarks of a liquidation proceeding."[31] The stay was lifted for these suppliers to pursue their claims and the monetary value of the claims was ordered held back from distribution to secured creditors.[32] The remarks of Dewar J. indicate that use of the *CCAA* as a liquidation vehicle may attract a more sympathetic judicial audience when suppliers are disadvantaged by the regime choice.

In *Quality Meat Packers Ltd., (Re)*,[33] suppliers of hogs to the debtor company had their rights under s. 81.2[34] *BIA* suspended as a result of the company filing a notice of intention under s. 50.4(1) *BIA*. The suppliers alleged a lack of good faith on the part of the company for accepting hogs in the days leading up to the filing. In disagreeing with the position that ordering goods in the face of insolvency constituted a lack of good faith, D.M. Brown J. stated that, "[o]ne normally would expect to see that kind of business activity by most companies which have decided not to close their doors, but instead *to*

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[30] *Puratone Corp., (Re)*, 2013 MBQB 171, 229 ACWS (3d) 632 [*Puratone*].
[31] *Ibid* at 20.
[32] What appeared to be a victory for the suppliers in *Puratone* came with substantial risk. They were ordered to make an undertaking as to damages resulting from the withholding of the funds pursuant to the resolution of their claims. The secured creditors valued their potential damages at approximately $25,000,000 and it appears as though the suppliers weighed their options and abandoned their claim. For a discussion of the undertaking, see *Puratone Corp., (Re)*, 2014 MBQB 32, 237 ACWS (3d) 756.
[33] *Quality Meat Packers Ltd., (Re)*, 2014 ONSC 2296, 239 ACWS (3d) 563 [*Quality*].
[34] See *BIA*, *supra* note 2 s 81.2.

attempt a restructuring to keep the enterprise continuing as a going concern."[35] [emphasis added]

The common thread running throughout these comments is the emphasis on withholding suppliers' rights where preservation of going concern value is possible. Where there will be no going concern value preserved, the intention of suppliers' rights as they exist under the *BIA* becomes frustrated through non-application. Recognition of suppliers' rights in the *CCAA* would address the tension present in the judicial commentary. However, the right itself will need to be reformed or it may hinder genuine restructuring proceedings.

V. Legislative Change

The use of the *CCAA* for liquidation proceedings is a divergence from the statute's original purpose. Suppliers' rights should be recognized in the *CCAA* due to the change in use of the statute. Part V examines proposed changes to s. 81.1 and what impact those changes could have on the insolvency system.

A. Repeal

The Standing Senate Committee on Banking, Trade and Commerce,[36] the Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals[37] have all recommended the repeal of s. 81.1. The grounds for repeal are

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[35] *Quality*, *supra* note 33 at 25.

[36] Senate Report, *supra* note 5. The report recommended repeal of the provision for the following reasons: Its technical requirements were unworkable; preferring suppliers lessened amounts available to other unsecured creditors; it gives rights to a creditor outside of the negotiated contract between the parties; it is a special interest hand out; and it limits the availability of operating credit for the company.

[37] Report on the statutory review of the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act* by the legislative review task force (Commercial) of the Insolvency, Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals, July 15, 2014 [Statutory Review of the Bankruptcy and Insolvency Act]. http://www.insolvency.ca/en/resources/DOCS-13606783-v1-JOINT_TASK_FORCE_REPORT_-_JULY_15__2014.PDF

largely based on the provision's unworkable requirements, its unfairness to other unsecured creditors, and its effect on the availability of credit.

The requirements of s. 81.1 have been criticized as unworkable and providing only "illusory" protection.[38] Evaluating these requirements is outside the confines of this paper. The provision's shortcomings due to its technical requirements militate toward its repeal. However, Parliament has indicated a desire to keep and amend the provision by altering its more unworkable elements.[39] Also, if the provision is not working as intended, but the policy basis for upholding it remains, then amendment or reform is more appropriate than repeal.

Statutory recognition of suppliers' rights is the best method currently available to prevent abusive ordering practices by debtor companies. The repeal of s. 81.1 would remove a deterrent to debtor companies abusing the stay of proceedings to benefit their secured creditors at the expense of suppliers. The resulting void would likely increase the abuse that Parliament has clearly identified as worthy of prevention.

The possible repossession of goods factors into a lender's calculations when determining the credit it is willing to advance. A diligent creditor will factor in a maximum thirty-day supplier claim in determining its available security and reduce credit accordingly. Those who argue for repeal based on the right's impact on credit markets are indicating their distain for the current form of s. 81.1. Through amendment of the right afforded suppliers, the impact on credit markets can be lessened.

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[38] *Ibid* at 3.26.

[39] For example, in the 2009 amendments of the *BIA* the notice requirement was changed from thirty days from the date of delivery of the goods to no later than fifteen days from the date of bankruptcy or receivership.

B. Full Adoption into the *CCAA*

Adoption of s. 81.1 into the *CCAA* would further the desirable goal of having a seamless priority structure across insolvency regimes[40] and would remove one incentive to pursue less efficient vehicles for achieving similar ends. Although the Senate Report recommended the full repeal of s. 81.1, it advocated for the preservation of s. 81.2 and that the "CCAA be amended to incorporate the priority rules in the BIA."[41] Professors Buckwold and Wood have argued that allowing for different priority positions depending on the regime chosen complicates risk assessment.[42] This complication disproportionately impacts less sophisticated creditors who may find themselves in a position well beyond their original expectations.[43]

Proponents of full adoption must be cognizant of the effects that repossession would have on a restructuring proceeding and the preservation of going concern value. It is not difficult to imagine the impact that repossession would have on a retailer who is intent upon successfully restructuring its business. Therefore, a different approach is required that recognizes how to best preserve the value of a restructuring company while acknowledging the rights of suppliers in a liquidation.

C. Section 81.1 Reform

One alternative is to determine whether suppliers' rights should apply in a *CCAA* proceeding on a case-by-case basis. A court could examine the viability of a plan before a supplier is prevented from repossessing its goods under s. 81.1.[44] If it is reasonable that a

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[40] *Century Services*, *supra* note 12.
[41] Senate Report, *supra* note 5 at 153.
[42] Buckwold & Wood, *supra* note 6 at 138.
[43] *Ibid.*
[44] Steven J Weisz and Constance Chan, "Unpaid Suppliers Right of Repossession" (1999) 16 Nat'l Insolv Rev 49 at 55.

going concern would emerge from the restructuring process, then the rights of suppliers would be stayed.

This approach is problematic as it requires a determination of the plan's viability early in the process. In many cases, the plan will not be fully articulated for some time due to ongoing negotiations and compromises between the debtor and its creditors. Furthermore, a threshold viability question will likely be a difficult one for a supplier to meet. Proving abuse by the debtor company in the face of a good faith threshold requirement, such as that in s. 11 *CCAA*, has proven difficult for suppliers given the precarious position of the debtor company.[45] However, there are cases where the debtor company admits there is no intention to put forward a plan to preserve going concern value. In these situations, staying the claims of suppliers appears only to allow for the bypassing of their rights to the benefit of secured creditors and the debtor company—exactly the type of statute shopping activity that is to be discouraged.

The United States Bankruptcy Code was amended in 2005 to allow for "twenty-day administrative expense claims" under § 503(b)(9).[46] Essentially, claims of a supplier who provided goods in the ordinary course of business within twenty days of the bankruptcy will be considered administrative claims. The result of § 503(b)(9), and its interaction with other Bankruptcy Code provisions, is that a debtor is unable to exit restructuring until these claims are paid in full.[47] The provision has been subject to

[45] *Agro Pacific, supra* note 8 at 43. Similar reasoning was adopted in *Quality*, supra note 33 at 25
[46] USC tit 11 § 503(b)(9) (2006).
[47] USC tit 11 § 1129(a)(9)(A) (2006).

criticism because it has led to the ballooning of administrative expenses and the resulting inability of some creditors to reorganize themselves.[48]

Another possible reform is converting the mode of realization from one of repossession to security in the form of a charge. Professor Ronald Cuming proposed that the right of recovery should be disconnected from the goods supplied or what happens to them afterward.[49] Instead, the charge approach in s. 81.2 should be adopted for s. 81.1 suppliers.[50] However, only a limited amount of the value of the goods supplied would be subject to security by the charge.[51] This is intended to strike a balance between the interests of suppliers and credit granting institutions.[52] The unworkable requirements that often act to the detriment of suppliers in realizing their right of repossession are replaced by a more workable charge that attaches to all assets of the debtor subject to certain exceptions.[53] Those arguing for repeal of s. 81.1 in its current form due to its impact on the availability of credit insist that credit is restricted in proportion to the theoretical maximum of a potential thirty-day goods claim. The proposed charge would decrease this theoretical maximum by ensuring only a limited amount is subject to the security while

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[48] Some reports suggest that, due in part to § 503(b)(9), only three retailers successfully restructured in the USA between 2005 and 2011. See Brendan M Gage, "Should Congress Repeal bankruptcy Code Section 503(B)(9)?" (2011) 19 Am Bankr Inst L Rev 215 at 218.
[49] 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 [Cuming]. Professor Cuming's article is cited by subsequent publications for his recommendations. However, searching for a publicly available copy of the paper in libraries, and appeals to Industry Canada, proved fruitless. Professor Cuming was kind enough to furnish the author with a copy of the report. This copy is an exact copy in substance, but may have differing page numbers from the original provided to Industry Canada based on formatting.
http://library2.usask.ca/gp/ca/ind/1998_unpaid_suppliers_ronald_cuming.pdf
[50] *Ibid* at 32.
[51] *Ibid* at 34.
[52] *Ibid* at 36.
[53] *Ibid* at 35. Cuming proposes the charge should have priority over all other "security interests, liens and charges including those held by the Crown or a municipal government" except a wage claim charge, "a purchase money security interest, a possessory lien that [arose] by operation of law or a lien arising under builders' lien legislation."

giving suppliers a more accessible tool to realize some value from the goods they supplied.

A consequence of the new suppliers' charge would be the conversion of unsecured suppliers into secured creditors when the charge is triggered. This would have implications for creditor classification under the *CCAA*.[54] However, reforming the rights of suppliers into a charge, instead of a right of repossession, addresses abuse of trade creditors by a debtor company and avoids jeopardizing a *bona fide* restructuring through repossession of assets.[55]

VI. Conclusion

Suppliers' rights under s. 81.1, and their interaction with the current use of the *CCAA,* illustrate the problems associated with differing priorities across Canada's insolvency regimes. Differing priorities encourage regime shopping and create incentives for self-interested decision-making. Where regime choice is affected by factors other than efficiency and the maximization of stakeholder value, results can be suboptimal.

Adoption of s. 81.1 as it currently stands into the *CCAA* would negatively impact the ability of companies to restructure. However, through reform of the right's mechanics, a more effective right can replace onerous technical requirements and lessen the negative impact on credit markets. Reforming the right into a charge, as suggested by Professor Cuming, would benefit all stakeholders in an insolvency proceeding including the restructuring company itself. Reform is necessary to ensure that suppliers' rights, as they exist under the *BIA*, continue to fulfill their intended policy goals as the use of insolvency legislation changes over time.

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[54] *Ibid* at 37-38.
[55] *Ibid* at 38.

Case Law

Agro Pacific Industries Ltd., Re, 2000 BCSC 837, 97 ACWS (3d) 383.

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Statute

Bankruptcy and Insolvency Act, RSC 1985, c B-3.

Companies' Creditors Arrangement Act, RSC 1985 c C-36.

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