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Bankruptcy: What Is It and Why Does It Matter to Insurers

Prepared by: Alexandre Maltas & Nicole Chang, with assistance from articling student Lauren Gnanasihamany

Introduction

COVID-19 has affected how individuals and companies work and operate businesses, and in the last several months, there has been a rising number of individuals and companies filing for bankruptcy. The purpose of this paper is to provide an overview of bankruptcy and insolvency, and why it matters to insurers. This paper will focus on the terms and process under the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 [BIA], with some references to the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36 [CCAA].

Meaning of Bankruptcy and Insolvency

"Bankruptcy" is a defined term under the *BIA*, and "means the state of being bankrupt or the fact of becoming bankrupt"¹. A "bankrupt" means "a person who has made an assignment or against whom a bankruptcy order has been made or the legal status of that person"².

In contrast, "insolvency" does not carry a legal meaning under the *BIA*. Therefore, even though the two phrases "bankruptcy" and "insolvency" tend to go hand in hand, the former is a legal status that triggers various rights and remedies under the *BIA*, while the latter is a broader and more general notion about the debtor's inability to pay, but does not carry legal meaning.

However, an "insolvent person" is defined under the *BIA*, and it describes the types of insolvency. Specifically:

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

(a) who is for any reason unable to meet his obligations as they generally become due,

(b) who has ceased paying his 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;³

In short, the definition contemplates two types of insolvency. The first is balance sheet insolvency, and the second is equitable insolvency. Balance sheet insolvency is when a debtor's total liabilities exceed total assets. Equitable insolvency is when a debtor cannot pay their debts as they become due.

Another key term in the *BIA* is the definition of a "debtor", which includes an insolvent person:

¹ *BIA*, s.2.

² *BIA*, s.2.

³ *BIA*, s.2.

Debtor includes an insolvent person and any person who, at the time an act of bankruptcy was committed by him, resided or carried on business in Canada and, where the context requires, includes a bankrupt.⁴

“**Act of Bankruptcy**” is a defined term under s.42 of the BIA, and provide a list of ten events that can trigger a bankruptcy, including:

- Debtor makes a fraudulent transfer of debtor’s property: 42(1)(b)
- Debtor gives notice to creditors that he has suspended or about to suspend payment of debts: 42(1)(h)
- Debtor cannot meet liabilities as they become due: 42(1)(j)

Distinguishing Receivership from Bankruptcy

Receiver

Bankruptcy and receivership are not synonymous. A receivership is when a receiver is appointed over the debtor’s assets. Receivership can take place completely outside of the bankruptcy process.

A receiver is defined in Black’s Law Dictionary as “a person appointed by a court for the purpose of preserving property of a debtor pending an action against him, or applying the property in satisfaction of a creditor’s claim, whenever there is danger that, in the absence of such an appointment, the property will be lost, removed or injured.”

Under the *BIA*, a receiver has a number of duties and powers. Receivers can take possession of all or substantially all of the property used by an insolvent or bankrupt person in relation to their business and the receiver can exercise control over that property. A court can also appoint a receiver to take any other action that the court considers advisable in the circumstances.

A receiver is appointed by a private appointment or a court appointment. A private appointment means that a receiver will be appointed if the security agreement with the debtor allows the creditor to appoint one. A court appointment is a court order made after an application by a creditor. Court appointments are guided by the Law and Equity Act s. 39 and the BC Supreme Court Civil Rule 10-2. The court will appoint a receiver when it is “just and convenient” to do so. In order to have a receiver appointed, a secured creditor will need to demonstrate that there is some jeopardy to the assets. If a receiver is not appointed.

It is also possible to appoint a Receiver- Manager. A Receiver-Manager is a receiver who is also given a mandate to run the debtor’s business. Receivers and Receiver-Managers can also be appointed under the BC Business Corporations Act (*BCBCA*). The powers and duties of Receivers and Receiver-managers to manage a company are detailed under sections 105 and 106 of the *BCBCA*. If a receiver-manager is appointed in respect to some or all of the undertakings of a corporation, the powers of directors and officers of that corporation cease in regards to those undertakings until the Receiver-Manager is discharged. As per the *BCBCA*, Receivers and Receiver-Managers must file a notice of appointment with

⁴ *BIA*, s.2.

the registrar within seven days of being appointed and file a notice of ceasing to act with the registrar within seven days of ceasing to act.

Trustee

A trustee is defined as a person holding property in trust. Like a receiver, a trustee can manage a debtor's estate, but trustees are only appointed in bankruptcy proceedings. Trustees appointments and powers are governed by the *BIA*. As per the *BIA*, a trustee must be licensed and may act for or assist a secured creditor. A trustee is in the same position as a receiver for the purposes of acquiring or retaining possession of property of the bankrupt person and can act anywhere in relation to obtaining possession of and realizing on the property of the bankrupt.

Trustees are under no obligation to carry on a bankrupt's business when, in the trustee's opinion, the realizable value of the bankrupt's property is insufficient to cover possible losses that may arise upon carrying on the business, and the creditors or inspectors have not secured the trustee against such possible loss.

Trustees have certain reporting obligations. They must report to the court if the estate is not fully administered within three years after bankruptcy and must provide reports from time to time. A trustee's fees cannot exceed 7.5% of the value remaining out once the claims of the secured creditors have been satisfied from the realization of the debtor's property.

Creditors

There are three different types of creditors: secured, unsecured, and preferred.

Secured creditors hold security for their debt. Under the *BIA*, secured creditors are defined as:

a person holding a mortgage, hypothec, pledge, charge or lien on or against the property of the debtor or any part of that property as security for a debt due or accruing due to the person from the debtor, or a person whose claim is based on, or secured by, a negotiable instrument held as collateral security and on which the debtor is only indirectly or secondarily liable...⁵

An unsecured creditors in a person who does not hold a security, pledge, or other property of the debtor as security for their debt. Unsecured creditors are paid out after preferred creditors and secured creditors.

A preferred creditor is not defined in the Act, but they are the creditors who are paid out first in bankruptcy proceedings according to the priorities set out in s. 136 of the Act. For example, an employee claiming wages have priority over other creditors under the *Wage Earner Protection Program Act* for up to seven times the worker's maximum weekly EI insurable earnings. Other priorities include claims on: costs to administer the bankrupt estate, including trustee fees and legal costs, maintenance and support payments, municipal taxes, and three months of a tenant's rent arrears if claimed by their landlord. Crown claims for taxes and other debts also have priority status above secured and unsecured creditors.

Preferred creditors are generally paid out first, followed by secured and then unsecured creditors. This order, and the rights of preferred creditors in particular, may be altered as a result of bankruptcy.

⁵ *BIA*, s.2.

Section 244 Notices

If a creditor is considering a proceeding under receivership or bankruptcy, they should be aware of s. 244 notices. Under s. 244 of the *BIA*, a secured creditor cannot realize upon their security unless they give 10 days advance notice of their intention to do so or the insolvent person consents to earlier enforcement. Form 86 under the *BIA* sets out the prescribed notice requirements. This section applies in relation to security over inventory, accounts receivables, or other property acquired by insolvent persons for use in their business.

The Bankruptcy Process

Both the *BIA* and the *CCAA* are federal legislation dealing with bankruptcy. The main difference between the *BIA* and *CCAA* is who it applies to - the *BIA* applies to personal and commercial bankruptcies, while *CCAA* applies to larger commercial bankruptcies where the corporate entity has more than \$5,000,000 in debt. The *CCAA* is also generally more flexible in its application. Otherwise, their bankruptcy processes are quite similar:

	<i>BIA</i>	<i>CCAA</i>
Who it applies to	Personal and commercial bankruptcies	Larger commercial bankruptcies where the corporate entity has more than \$5 million in debt
Who can commence proceedings	Creditor or debtor <ul style="list-style-type: none"> • Creditor can file court application seeking bankruptcy order if debtor owes the creditor at least \$1,000 on an unsecured basis and the debtor can committed an act of bankruptcy within 6 months preceding the court application • Debtor can make a voluntary assignment into bankruptcy under s.49 	Creditor
Step 1: Appoint a Trustee	<ul style="list-style-type: none"> • Involuntary bankruptcy: Creditor can petition for a trustee to take over and manage the assets OR • Voluntary bankruptcy: Debtor can assign into bankruptcy and a trustee will be appointed by consent 	<ul style="list-style-type: none"> • Appoint Monitor to take over and manage assets • “Monitor” must be a trustee within the meaning of the <i>BIA</i>: <i>CCAA</i> s.11.7 • B.C. has model <i>CCAA</i> initial order
Step 2: Stay of Proceeding	Under the <i>BIA</i> , there is an automatic stay of proceeding, which prevents creditors (other than secured creditors) from taking steps to seize or otherwise move against debtor’s assets	Not automatic – must be ordered by court
Step 3: NOI	<ul style="list-style-type: none"> • NOI initiates a 30 day stay • <i>BIA</i> allows multiple court applications for extension, each extension no more than 45 days • Total extension cannot be longer than 6 months 	N/A

	from the date the original NOI was filed	
Step 4: Prepare Proposal or Plan of Arrangement	Trustee prepares Proposal <ul style="list-style-type: none"> • Within 5 days of NOI being filed, must notify creditors within 5 days from when Notice of Intention is filed • Within 10 days of NOI being filed, must file cash flow statement, report on reasonableness of cash flow statement, and a representation from debtor that the cash flow statement is reasonable • Within 30 days of NOI being filed, trustee must file proposal 	Plan of Arrangement
Step 5: Meeting of Creditors	Meeting of creditors to vote on proposal within 21 days of proposal being filed: <ul style="list-style-type: none"> • If proposal is rejected, then debtor deemed to have made an assignment into bankruptcy and trustee becomes trustee in bankruptcy • If proposal accepted by 2/3 of creditors (in value), then application for court approval 	Meeting of Creditors <ul style="list-style-type: none"> • If Plan is rejected, there is no automatic bankruptcy under CCAA • If Plan is accepted by 2/3 creditors (in value), then application for court approval to determine if the Plan is fair and reasonable
Step 6: Proposal	Court approval of Proposal	Court approval of Plan
Step 7: Carry out terms	Receiver will carry out terms of Proposal	Monitor will carry our terms of Plan

How to Lift a Stay of Proceeding

The stay of proceeding is significant since it is automatic under the *BIA*, and prevents new actions from being commenced against the bankrupt, suspends existing actions against the bankrupt, or stays the enforcement of judgment against the bankrupt. For example:

1. If the party has a claim against a party that has filed for bankruptcy;
2. If the party has an existing claim, and is considering issuing a third party notice against a party that filed for bankruptcy;
3. If the party has an existing claim, and the other party filed for bankruptcy; and
4. If the party has obtained judgment against a party, and the party filed for bankruptcy.

In each of these situations, the stay of proceeding thwarts the party's efforts to move the litigation forward, bring an action against the bankrupt, or enforce judgment against the bankrupt.

The stay of proceeding may be lifted by court order, if the applicant can demonstrate that they will be materially prejudiced by the continuation of the stay or that it is equitable on other grounds to lift the

stay⁶. For example, a stay has been lifted to allow the claimant in a motor vehicle action to establish liability so that it could make a claim against the bankrupt's insurer⁷.

Exempted Property and Surviving Debts

The *BIA* and *Court Order Enforcement Act* sets out some properties that are exempt from bankruptcy. Some key properties are: RRSPs/RRIFs, Registered Disability Savings Plans, Principal Residence Equity, and Insurance based annuities. For Principal Residence Equity, the exemption is for \$12,000 of equity or \$9,000 outside of Greater Vancouver.

Certain debt claims will survive an assignment into bankruptcy. These include: civil claims for intentional assault, claims for fraud, embezzlement, misappropriation of funds while acting in a fiduciary capacity, claims for spousal support, and student loans if the debtor is bankrupt less than 7 years after finishing school.

Conclusion

With increasing number of individuals and businesses filing for bankruptcy during these unprecedented times, it is important to understand the bankruptcy process, and how it affects a claimant's ability to seek recovery against a bankrupt. As illustrated in this overview, bankruptcy legislation is technical, and various mechanisms are triggered upon filing for bankruptcy, including an automatic stay of proceeding under the *BIA*, which hinders a claimant's ability to recover.

For more information on this topic or for further questions, please contact:

Alexandre Maltas
D. 604. 891. 7235
E. amaltas@wt.ca

⁶ *BIA*, s.69.4.

⁷ *Buchanan v. Superline Fuels Inc.*, 2007 NSCA 68,