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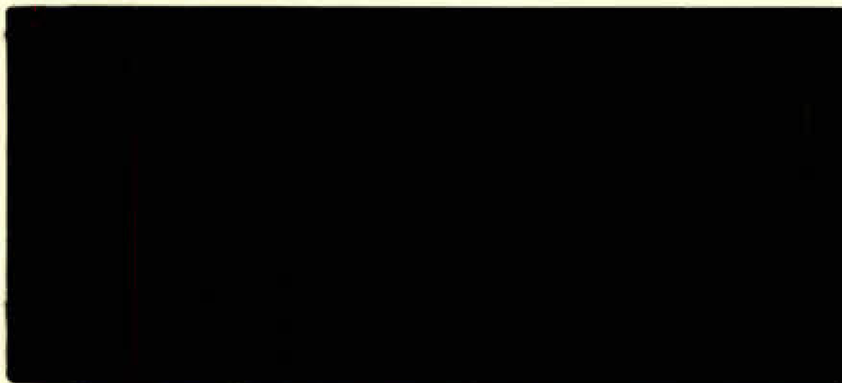

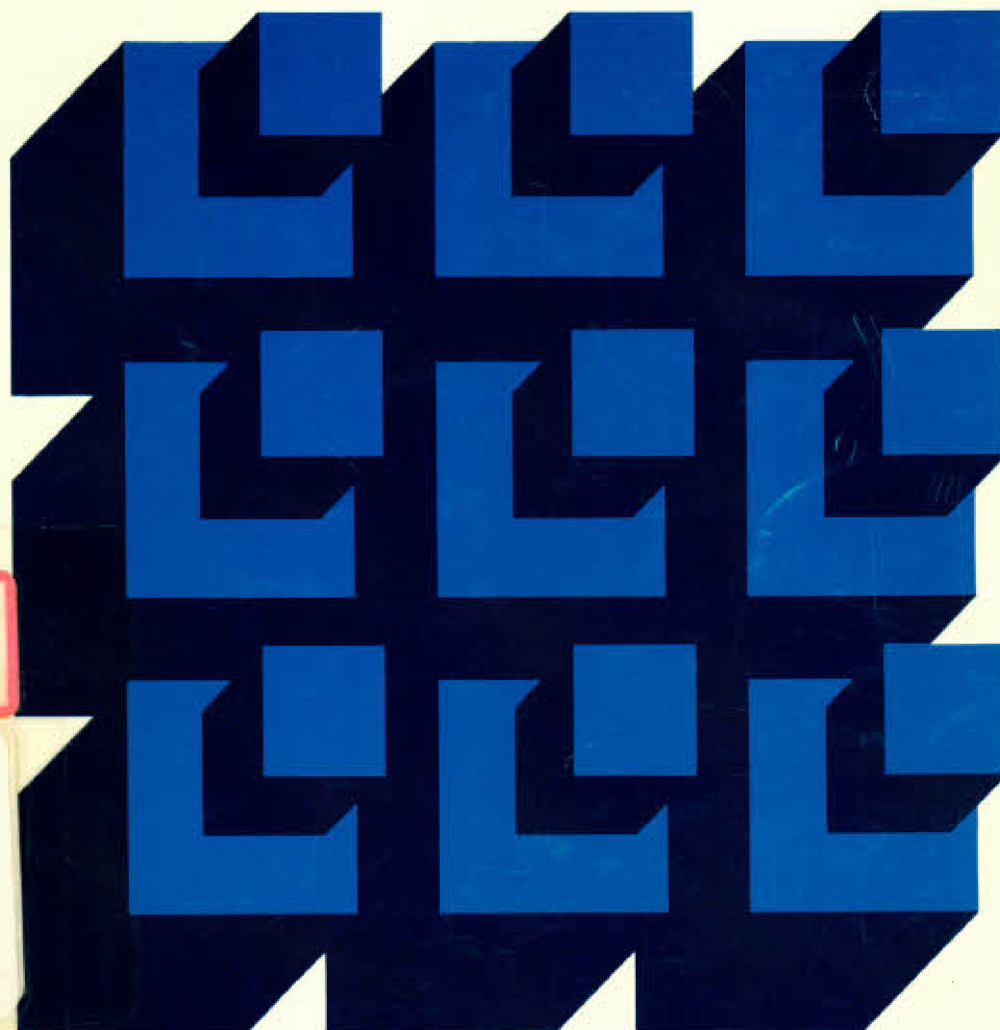

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Recent Proposals to Reform the Bankruptcy Act: An Assessment

by

B.-M. Papillon

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ABSTRACT

This paper represents a critical analysis of recent proposals to reform the Bankruptcy Act. First, the Bankruptcy Act is identified as a policy for facillitating exchanges and as a framework for economic adjustment; this provides a basis for its initial interpretation. After reviewing the aspects of the Act most affected by recent reform proposals, the paper critically analyzes the aims of the Act and of the reforms, as stated by the legislators. With this purpose in mind, a brief summary of the origins of the present legislation is presented. For present purposes, the current Act may be considered similar to the legislation enacted in 1949, which itself followed the broad lines of the 1919 Act.

The arguments advanced in the debate over reforming the Act are essentially redistributive, in that they they argue for more favourable treatment for a particular group of creditors. Starting from the premise that the role of this legislation is as a policy framework for adjustment and exchange, the paper develops three criteria for evaluating the Act and the proposed changes to it. When these criteria are applied, the proposal to institute a protection fund for wage earners of bankrupt businesses, as it now stands, does not appear to be justified. Some minor modifications to the unemployment insurance program could offer the same degree of protection while providing a better opportunity to employees to become more actively involved in the efficient management of the assets of firms in difficulty.

The other major focus of recent reform packages is the behaviour of secured creditors vis-à-vis the reorganization procedures provided by the present legislation. At the risk of complicating the reogranization procdures, it has been proposed that the legislation be modified to cover secured creditors. Applying the three criteria introduced earlier, however, suggests rather that the simplicity of these procedures should be maintained and that creditor priority could be established on the basis of the "first in, first out" principle, taking explicitly into consideration task specialization between, first of all, financial intermediaries, whose job it is to channel savings to projects with the highest value, and, second, suppliers, whose job it is to offer goods and services that best meet the needs of their clientele. Our criteria also suggest that Crown claims should enjoy absolute priority over other claims.

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FOREWORD

There are many reasons firms may fall into bankruptcy: poor management, economic slowdowns, unexpected cost increases, and so on. Moreover, as needs change and technological innovation opens up new opportunities, certain firms operating in the economy gain value, while others lose value. No matter what the cause, an insolvent firm, which is a candidate for bankruptcy, is essentially unable to attract sufficient resources to meet its current obligations. The Bankruptcy Act provides a framework for managing the assets of such a company.

Recent proposals for reforming the Act are only the latest in a long series of such attempts over the past twenty years. During this period, the perceived shortcomings of the legislation, as well as the approaches to rectifying them, have changed. By focusing on the role of the Bankruptcy Act and on its origins in Canada, the present paper offers a critical analysis of the recent reform package and an exploration of some alternatives.

This paper was prepared by Benoît-Mario Papillon, an economist at the Council. It was undertaken as part of the Council's report on *Manufacturing Firm Adjustment*. The content of the paper remains wholly the responsibility of the author and its findings have not been endorsed by the members of the Economic Council of Canada.

Judith Maxwell
Chairman

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1 INTRODUCTION

One of the most important items on the government's economic agenda is facilitating trade or exchange. For example, the massive support that the Canadian government poured into railway development at the turn of the century served to open up and develop vast areas of the country by allowing farm products to be exchanged for manufactured goods and services from the urban markets of the east and from other countries. The Canadian government's active involvement in the General Agreement on Tariffs and Trade and the Free Trade Agreemnt are also aimed at facilitating exchange by dismantling trade barriers.

For both individuals and businesses, the process of exchange and the realization of gains from trade is inextricably linked to task specialization. As needs change and technology develops, new trading possibilities are opened up and new tasks created. At the same time, other tasks decline in value and become out-of-date. In order to benefit from exchange, skills and resources must be redirected to new tasks. Governments' efforts to facilitate trade, therefore, must go hand-in-hand with the development of an adequate framework for allocating resources to new projects and new ventures, or with what might be termed a framework for adjustment.

Government efforts to provide such a framework for adjustment fall into two categories: framework policies and sectoral policies.[1] Awarding subsidies to particular companies in a particular industry is an example of a sectoral policy. Framework policies, on the other hand, are more general in nature, tending to affect the economy as a whole. Examples of framework policies include provisions of the Income Tax Act granting special treatment to research and development outlays, unemployment insurance, and programs to finance firms involved in personnel training. Several other acts can be considered examples of framework policies, including the Corporations Act, the Competition Act, and -- the subject of this discussion -- the Bankruptcy Act.

Adjustment policies provide an adequate framework when they are conducive to good decisions on the allocation of resources and, among other things, decisions regarding terms of trade. The implicit and explicit contracts that bind people to a particular project with a common goal are an expression of these terms of association and trade. The Bankruptcy Act provides some of the clauses of these contracts, and in cases of insolvability it offers a structure for revising a few others.

According to statistics released by the Superintendent of Bankruptcy, there were 8,664 cases of commercial bankruptcy in 1989. The assets reported in these business failures amount to

almost $200 million, with liabilities of close to $2.2 billion. This means that the creditors involved in these bankruptcies suffered financial losses totalling about $2 billion.

In an dynamic economy, open to new ventures (which can be considered testing grounds for new ways of producing exchange values), there will always be firms and projects that are unprofitable in the sense that they fail to cover the opportunity cost of the resources allocated to them. This is simply part of the process by which knowledge is acquired about the needs, skills and resources available in a society where a wide range of initiatives is permitted, with all the changes that such initiatives inevitably produce. The financial losses reported in commercial bankruptcies can be considered in part as an investment. From this point of view, the prevailing bankruptcy legislation directly determines the amount of these losses, and the incentives it provides directly govern the distribution of these losses among the various participants in a particular enterprise.

A state of insolvability is a pre-requisite to the invocation of procedures under the Bankruptcy Act. However, insolvability does not necessarily lead to bankruptcy. According to a survey of the manufacturing sector, about 50 per cent of the total debt reported in bankruptcy cases is secured, generally speaking.

Secured creditors do not come under the jurisdiction of the Bankruptcy Act as it now stands.

The same survey indicates that in the vast majority of cases, creditors who do come under the jurisdiction of the Bankruptcy Act end up with a total loss. This would indicate that, as things now stand, the potential return to creditors under the Act is not a significant factor in the decision to invoke it or not. Indeed, according to several sources, at least as many cases of commercial insolvability appear to be handled without, as with, recourse to the Act. This suggests that *the total financial losses associated with commercial insolvability in 1989 were on the order of $4 billion* (rather than the figure of $2 billion cited earlier) -- close to 1 per cent of the national product or a little more than 5 per cent of total annual business investment in the economy.

THE RECENT REFORM PROPOSAL

The document entitled *Proposed Revisions to the Bankruptcy Act*, released in June 1988 by Consumer and Corporate Affairs, addresses five issues related to commercial bankruptcy: employee creditors, secured creditors and receivers, commercial reorganizations, unpaid suppliers, and crown priority. The intention of these proposals was to modify, rather than completely overhaul, those points of the Act that needed

changing, since the latter approach has frequently proved unsatisfactory in the past.

Chapter 2 briefly describes the main procedures under the current Act. Chapter 3 sketches the historical background to the current reform proposals, then critically analyzes previous arguments and develops criteria for assessing the various proposed changes.

The problem of employee creditors has become a focus of recent debate on bankruptcy legislation reform. One of the most discussed proposals is the creation of a wage-earner protection fund, an option that would involve only relatively minor changes to the present Act. This program would constitute a form of wage insurance similar to unemployment insurance. After examining wage-earner debt from the point of view of exchanges, Chapter 4 weighs the proposed protection program against an alternative approach involving minor modifications to the unemployment insurance program.

Other reform issues raised in the policy statement tabled in the House of Commons in 1988 are discussed in Chapter 5. These proposals involve redefining the order of priority of various creditor rights upon the assets of an insolvent firm. New regulations are also proposed for receivers and commercial reorganizations. The common thread linking all these proposals

is the question of priority, which implies that they are best jointly addressed.

2 SUMMARY DESCRIPTION OF THE BANKRUPTCY ACT

Under Article 91(21) of the British North America Act, the Parliament of Canada has authority over bankruptcy and insolvency. The first Bankruptcy Act was enacted by Parliament in 1919. Another was passed in 1949, and, including the amendments adopted in 1966, it is this Bankruptcy Act that remains in force today. In its current form, the Act is a 123-page text of law with 242 sections (R.S.C. 1985, ch. B-3).[1]

Sections 1 to 4 concern the Act's title and define the basic set of terms used in the text. The other sections of the Act are divided into ten parts. Part 1 (Sections 5 through 41) deals with the subject of the administrative officials who apply the Act before and beyond the Courts. The roles of the Superintendent and Official Receivers (federal civil servants reporting to the Minister of Consumer and Corporate Affairs) are defined, as well as those of trustees, who are private agents (usually accountants) operating under a licence issued by the Minister upon recommendation of the Superintendent. The trustee is most directly involved in the affairs of a bankrupt business between the time bankruptcy is declared (note that the official date of bankruptcy sometimes predates the declaration) and the time the proceeds are distributed to preferred and unsecured creditors. The bankrupt chooses the trustee, although a meeting of creditors can select a different trustee by special resolution.[2]

Much of Part I of the Act is concerned with specifying the powers of the trustee; for instance, Section 30 reads in part as follows: "The trustee may, with the permission of the inspectors [chosen by creditors], do all or any of the following things:

- sell or otherwise dispose of for such price or other consideration as the inspectors may approve all or any part of the property of the bankrupt... [...]

- carry on the business of the bankrupt, in so far as may be necessary for the beneficial administration of the estate..."

The Bankruptcy Act stipulates how legal action may be initiated by creditors or by the bankrupt himself. There are three possible procedures: a petition for receiving order (initiated by a creditor), the assignment of all property of the bankrupt for the general benefit of creditors (initiated by the bankrupt), and the lodging of a proposal with a trustee (initiated by the bankrupt). Part II of the Act (Sections 42 through 49) provides more detail on the first two of these procedures. Section 42 provides a list of acts of bankruptcy, the most common being 42(1)(j), "if [the bankrupt] ceases to meet his liabilities generally as they become due." Section 43 concerns the bankruptcy petition itself, including its form and the grounds

the court[3] must consider in deciding whether the petition should be accepted or dismissed. Article 43(7) reads as follows:

> "Where the court is not satisfied with the proof of the facts alleged in the petition or of the service of the petition, or is satisfied by the debtor that he is able to pay his debts, or that for other sufficient cause no order ought to be made, it shall dismiss the petition."

Paragraph 42 (1[j]) is usually interpreted as referring to a general interruption of payments by the debtor to a large number of creditors; the petition for receiving order, under the Bankruptcy Act, is not intended for ordinary civil litigation, but rather as a collective recourse that should benefit creditors as a whole.[4] The same general principle applies to an assignment filed by a bankrupt or debtor; the person must be insolvent (Section 49), in the sense that he "is for any reason unable to meet his obligations as they generally become due" (definition of "insolvent person" in Section 2, Paragraph a).

A proposal can be initiated by an insolvent person or a bankrupt (Article 50 [1]). Part III of the Act specifically concerns this kind of procedure. The proposal must be lodged with a licensed trustee, who will call a meeting of the creditors affected by the proposal. The creditors will decide whether to accept or reject the proposal by special resolution ("a majority in number and three fourths in value"). If the proposal is

rejected, the debtor "shall be deemed to have made an assignment on the day the proposal was so filed" (Article 57 [1]). If a debtor defaults on any proposal once accepted, it is considered an act of bankruptcy (Paragraph 42(1(i)).

The remainder of the Act contains 176 sections divided into seven parts with the following titles: Property of the Bankrupt, Administration of Estates, Bankrupts (Duties, Examination, Arrest, Discharge), Courts and Procedure, Bankruptcy Offences, Miscellaneous Provisions, and Orderly Payment of Debts. Finally, *it should be noted that, while secured creditors are explicitly referred to on many occasions in the Act, it is usually with the objective of limiting the application of the Act and preserving their rights*. For instance, Section 69 under "Stay of Proceedings" states that upon the filing of a proposal or upon the bankruptcy of the debtor, creditors with a claim provable in bankruptcy are not allowed to commence or continue any action for the recovery of a claim; it then describes the very specific conditions under which secured creditors are also constrained by this rule.

3 REFORM OBJECTIVES AND ROLE OF THE ACT

HISTORICAL OBJECTIVES

The 1949 Act

Aside from a few minor changes related to the powers of the Superintendent, the Bankruptcy Act as it now stands is identical to that adopted in 1949. The objective of that Act "like any bankruptcy legislation" was "designed to provide machinery for liquidation and distribution in an equitable manner of the estates of insolvent persons."[1]

The 1949 Act was itself modelled on the 1919 Act; several minor differences notwithstanding, it is accurate to say that the present legislation dates back to the turn of the century. The objective of the Act adopted in 1919 was "to give uniformity in all commercial matters pertaining to bankruptcy."[2] Although bankruptcy was and is a federal responsibility, between 1880 and 1919 successive federal governments declined to exercise their jurisdiction. The result was a patchwork of provincial laws, and it was out of concern for standardization that the 1919 Act was born.

When the provision in the 1919 Act allowing a debtor to put proposals to his creditors without a formal receiving order or

assignment of goods proved subject to abuse, it was revoked in 1923 and replaced in part by the Companies Creditors' Arrangement Act, adopted in 1933. The 1949 Bankruptcy Act reinstated the provisions in force between 1919 and 1923 and made it possible for an insolvent person to "make a proposal to his creditors without making an assignment or having a receiving order made against him."[3] The Companies Creditors' Arrangement Act was maintained and its role, distinct from that of the Bankruptcy Act, was described as follows: "the Companies' Creditors Arrangement Act is primarily concerned with the rights of investors such as bond and debenture holders described by the Act as secured creditors, while the Bankruptcy Act is concerned with the rights of ordinary creditors and that the two should not be intermingled."[4]

The 1949 Act was the culmination of a long process of reform similar in some ways to the reform process under way today, which began in 1970 with the submission of the Tassé Report. Like the bills tabled between 1975 and 1984, the 1946 bill was aimed at instituting a broader act that would replace other legislation, such as the Companies Creditors' Arrangement Act.[5] In the latter case, the aim was "to bring all corporate reorganizations under the terms of the Bankruptcy Act,"[6] one of the reasons being "the desirability of eliminating certain alleged abuses of the existing machinery under the Companies' Creditors Arrangement Act

by virtue of which in some cases ordinary unsecured trade creditors have been defrauded."[7]

The broader approach taken by the bill originally presented to the Senate in 1946 was not retained in the 1949 Act. Among other arguments made against this approach was that "the existing provisions of the Bankruptcy Act preserving the rights of secured creditors should be left undisturbed."[8] There was also opposition expressed to the Senate to the "extension of the traditional bankruptcy field into wider areas."[9] More specifically, the brief submitted by the Toronto Board of Trade to the Senate Standing Committee on Banking and Commerce argued that "the Bankruptcy Act is an efficient instrument for enabling traders to realize claims on trade debtors."[10] If this was indeed true at the time, it is no longer. The manufacturing sector survey cited earlier found that, in the vast majority of cases, the retailers and suppliers or trade creditors involved in bankruptcies lost everything.

The Tassé Report and Recent Reform Proposals

The underlying principles of recent proposals for reform and the related debate may be distilled to three basic objectives: justice and equity, the public interest, and accessibility of credit. In the course of the long debate over the present Act, these objectives have been linked to sometimes markedly different

views of the issues. For example, the Colter Report, tabled in 1986, includes among its main concerns the survival of firms, while the Tassé Report does not even refer to the notion of firm in its study of creditor-debtor relations. Clearly, the precise meanings of terms have evolved over time.

For example, the concept of equity is sometimes invoked in discussions of the need to rehabilitate heavily indebted debtors. Yet equity also comes up in reference to the need to strike a reasonable balance between the powers of debtors and creditors. Similar changes can be discerned in the meaning of the concept of the public interest.

The Tassé report raised the issue of public interest with reference to the need to set up a just and honest system, free from abuse, for resolving conflicts between a debtor and his creditors. More recent opinions of the Act have frequently referred to the public interest as justification for reforms to make commercial reorganizations easier.

The need to protect the credit system, which was stated in the Tassé Report, is in some ways related to the third basic objective -- accessibility of credit. This objective, however, has most often been championed in relation to proposed measures or legislative changes designed to restrict the advantages involved in using securities. The five-point discussion of

commercial bankruptcies in the most recent proposal for revising the Act provides more practical justifications for these three basic objectives. With respect to the first of these items (wage-earner protection), the proposal to set up a wage-earner protection fund is aimed at ensuring rapid payment of employee claims.

The purpose of the measures proposed for secured creditors and receivers is to ensure adequate protection of assets, to prevent precipitous liquidations, and to encourage reorganization attempts (in the public interest). Aside from the advisability of having secured creditors involved in reorganization attempts, essentially the same arguments are invoked for the proposals regarding commercial reorganizations.

The reasons cited for restricting crown priority include assisting small-business and individual creditors, and encouraging the survival of viable firms by making it easier to develop reorganization plans. The measures proposed on behalf of unpaid suppliers are intended to rectify the unjust situation now faced by these parties.[11]

OPERATIONAL ASSESSMENT CRITERIA

Limitations of Proposed Objectives

The objectives of equity and justice, the public interest, and (perhaps) accessibility of credit can be considered fundamental principles. Any reform proposal that violates one or more of them is unacceptable from the outset. However, a number of reform packages are possible that are in accordance with principles. The problem is thus that the objectives are too broad.

As a counterpart to these very general objectives, a number of specific changes have been proposed, but the rationale for them sometimes goes no further than a simple description of their probable effects without any attempt to explain their substance. For example, one of the arguments invoked for the proposed changes in the area of commercial reorganization was that secured creditors must be included in the procedures. It is entirely sensible to expect such participation as long as amendments to the Act retain the link between secured creditors and firms. But this begs the question of whether or not the participation of creditors, secured or otherwise, is a good idea. Another example is provided by one of the arguments raised in favour of instituting a wage-earner protection fund. It is argued that this will allow such claims to be repaid fully and more rapidly.

Yet the question remains whether it is fair to accord such special treatment to one type of claim.

Another very general failing of almost all arguments offered in the reform debate is that they are essentially redistributive, whereby one group of creditors receives preferential treatment relative to others. By positing efficiency gains in the allocation of resources, economic criteria help us to transcend these arguments, which have never formed a basis for consensus in a complete reform package. Efficiency implies that no further net gains in an exchange are possible. Each type of claim is based on a particular type of contract; because contracts are at the heart of the resource allocation process, economic criteria provide a framework for analyzing the effects of the various reform proposals on the content and execution of contracts.

Role of the Act and Its Implications

From the economic standpoint, the role of legislation like the Bankruptcy Act is to facilitate gains from exchange. To this end, the Act operates at two levels: first, by establishing a framework compatible with exchanges and the pursuit of associations, and, second, by establishing rules that determine (or help determine) the terms of exchange and association.

It is essential to have terms of association or exchange, as specified in contracts, for there to be gains from the exchange or association. One of the pre-requisites for exchange and gains from exchange between two individuals is mutual agreement on the prices of what they are exchanging. In the case of an association or a project, the terms of association will often include other elements beside the price of the resources that each is contributing. But, again, if the terms cannot be determined to the satisfaction of the parties to the association, the association will not last for long. The reorganization procedures prescribed by the Bankruptcy Act provide a good illustration of the role of this legislation in determining the terms of association; in the case of reorganization, it involves determining the new terms of association (or separation) between the parties in light of the situation of insolvency.

By viewing role of legislation from this perspective, it becomes possible to deduce a number of operational assessment criteria or efficiency criteria. First, the terms of association as determined directly or indirectly by legislation should be as clear as possible in order to avoid ambiguity and the often difficult job of resolving such ambiguity. Second, legislation should offer a framework in which the true preferences of and constraints on the parties involved in an exchange or association remain in the open, so as to minimize the strategic options and rivalry between the parties participating in a single association

or project. Third, the legislation should not bias its own application in one direction or another; the preferences and constraints that the legislation helps to reveal should be the sole determining factors of the results obtained through the application of the legislation.

The three criteria established above are closely interrelated and have implications that make them even more relevant to the current debate. As an example of their interaction, it might be noted that a clear definition of terms implies better communication between the parties as to their true preferences and constraints. With respect to implications, the second criteria implies, for example, that the legislation should provide a framework where the greatest possible number of creditors (or their designated agents) are encouraged to participate in the procedures provided by the legislation, a goal that supports the earlier argument that the legislation should encourage greater participation by all creditors.

4 PROTECTION OF EMPLOYEE CREDITORS

Under the current Bankruptcy Act, an employee is entitled to claim as a preferred creditor up to $500 in back wages earned during the three months preceding the bankruptcy; the portion of his claim exceeding $500 is assigned to the category of ordinary creditor. The proceeds realized from bankruptcy property are distributed in a fixed order, with secured creditors coming first. While they are not subject to bankruptcy legislation, they take precedence over all other creditors. Next in line come preferred creditors, which include several categories; wage-earners come in fourth position, after funeral expenses, administration costs and a levy out of dividends to cover the services of the Superintendent. There are six other categories of preferred creditor following wage-earners (including municipal taxes, rent arrears, etc.). In last place come ordinary creditors.

According to the data collected in the survey within the manufacturing sector, the amount of preferred claims for unpaid wages is relatively low. Wage debts represent only about 10 per cent of all preferred claims. The total of preferred claims relative to the total of all debt (secured, preferred and ordinary) also represents only about 10 per cent. This means that, overall, wage claims represent only about 1 per cent of total debt. According to the same survey, the bankruptcy

dividend or average recovery on preferred claims works out to about 6 per cent. This means that the average loss on claims is more than 90 per cent.

It proved impossible to produce a separate estimate for wage-earner creditors as a group. In light of the low overall dividend value and the fact that wage-earners follow administration costs in the distribution order, it can be assumed that the losses are substantial in very many cases.

BANKRUPTCY CLAIMS AS AN INSTRUMENT OF EXCHANGE

Origin of Wage Claims

A company requires a wide array of resources in order to operate. To secure access to these resources, the company's management enters into a variety of contracts. These contracts establish the conditions of exchange between the company's management and the owners of the resources. There are two basic types of contracts: those for which all the conditions are met immediately and those involving some kind of time frame (*staggered contracts*).

The time factor involved is very often a key element in exchange gains, such as when, for example, savers are looking for a place to store their cash for future use at the same time as

the management of a company is looking for cash to invest in resources in anticipation of future returns. On the other hand, the time frame for fulfilling all the conditions of a contract may not be critical to exchange gains in certain cases, yet may still influence the size of net gains. For example, the fact that suppliers can deliver services or goods on credit, to be paid on specific dates according to the quantities actually used, greatly simplifies transactions and reduces administrative overhead.

A contract between an employer and an employee (and the wage debt that it entails), is one instance of a staggered contract. As is the case for suppliers of goods and services, the fact that the wage-earner is paid at certain specified intervals reduces administrative overhead. This practice means that, during the time between the wage instalments, one of the parties to the contract will be a creditor relative to the other party. Like a supplier of goods and services, the employee (as the supplier of his work and his expertise) will be the creditor. Debts involving wages and other benefits reported in bankruptcy cases arise in part from this business practice. In the case of non-wage monetary benefits (e.g., vacation pay), the instalment periods are farther apart than for wages, with the result that such benefits may represent a significant part of employees' bankruptcy claims.

Besides business practices, the particular circumstances of a firm and its environment may also be important in wage debts. Because they are employed by a firm, employees anticipate a certain flow of future income (subject to a variable degree of certainty). Accepting that payment for work already accomplished will be made at some future date can be considered an investment by the employee in this future income flow, if agreeing to this delay may contribute to the firm's survival. The alternatives open to him compared with his anticipated situation should he stick with the firm will play an important role in his decision either to make such an investment or to leave the company when a pay cheque falls overdue. These alternatives include the possibility of finding another job with a comparable salary and the possibility of applying for unemployment insurance benefits.

Wage Claims Versus Other Types of Claims

The fact that both the proposed reforms and current legislation confer a special status upon wage claims implies that they are different in some way. What is the nature of this difference in terms of allocation of resources? Or, more precisely, are wage claims based on the use of a particular resource, in this case labour, or rather on the type of contract or the particular mode of access to this resource?

When an engineer from a specialized engineering firm performs certain tasks for a client firm, he provides this firm with his labour, just as an employee does, without being considered an employee of the firm in question. He acts more as a supplier of services. Personnel agencies are another example of this type of situation.

Thus employee status and wage claims do not depend on the firm's use of a particular resource, in this case human labour, but rather on the mode it utilizes to access this resource. This observation remains true whether the firm purchases goods or services.

The purchase of a good or a service from a supplier can be considered a way for the firm to gain access to the human input that the supplier controls in order to produce this good or service. Downstream vertical integration on the firm's part provides it with direct access to this human input, with the result that, in cases of insolvency, wage claims replace supplier claims.

If a firm is viewed as one element in the chain of production, the size of its staff is an indirect measure of what it produces itself, while what it purchases in goods and services represents the part of the value of its output that is delegated to other firms. It is this latter portion that gives rise to claims by

various suppliers of goods and services, while wage claims are associated with the value added by the firm.

In the final analysis, therefore, the difference between wage claims and supplier claims lies in the particular way economic activities are structured in terms of types of contracts and means of access to resources.[1] Each type of debt corresponds to a particular type of contract; accordingly, assessment of legislative change and proposals for new programs, such as the protection plan, must examine how such changes will influence the behaviour of employees and employers with regard to employment conditions.

PROPOSED REFORM PACKAGE

The most recent reform proposal submitted by Consumer and Corporate Affairs (CCA) recommends, under the heading "Wage-Earner Protection," that the government establish "a Wage-Earner Protection Program providing direct compensation of unpaid wages." A very similar proposal was also made by the Advisory Council on Adjustment in its report.

According to the CCA proposal, the present section of the Act under which employees are granted the status of preferred creditor for wages claims up to a limit of $500 would be abolished. The employee would be entitled to submit claims to

the wage-earner protection board. Eligible claims would include 90 per cent of gross wages and vacation pay earned within the six months preceding the bankruptcy, up to a maximum of $2,000. The program would be administered by the federal government, which would itself have ordinary creditor status against the defaulting employer.[2]

A measure that has frequently been put forward as a way to provide better protection for wage-earners is the idea of "super-priority" for wage claims. i.e., that wage debt reimbursement would take precedence over all type of claims. Wage claim super-priority was not well received by the parliamentary commission, however;[3] it pointed out a number of implementation problems. For example, the secured loan system would have to be changed. Under the proposed system, a secured creditor would receive the liquidated value of the security minus the wage claims entitled to super-priority. However, the constraints or uncertainty that would be generated by super-priority have some precedent in the current system, since Article 178(7) of the Bank Act imposes a similar restriction on banks.[4]

ASSESSMENT OF PROPOSED PROTECTION FUND

The Costs and Extent of a Protection Plan

The most recent version of the CCA reform package provides no estimate of the total claims that might be made annually against a wage-earner protection fund. The 1986 Colter Report included such an estimate, however -- some $50 million a year. Yet this estimate can only be considered conservative, since it is based on the incidence of bankruptcy prior to the implementation of a protection plan. A more generous treatment of employee claims, however, will have an impact on bankruptcy patterns.

From the viewpoint of legislative and institutional changes, bankruptcy is the result of business and accounting practices that were tailored to the needs of the moment, combined with developments lying outside the control of the business partners (the economic climate, technological change, and so on). Some recent empirical research by Baldwin and Gorecki has produced estimates of the number of business failures and plant closings a year nationwide. They indicate that these events are not unusual and that there are a wide range of circumstances that can lead to commercial insolvability.[5] Just as the implementation of an unemployment insurance plan led to changes in the nature of job offerings (seasonal employment is a good example), it is logical to assume that the proposed protection scheme would lead to

adjustments in the conditions of employment termination -- since these conditions are one element among the many governed by labour contracts between employers and employees.

The issues involved in the proposed protection plan are not the same for wage arrears and for claims for other monetary benefits, such as pension plans.

An employee's non-wage monetary benefits are generally tied to his time of service. Thus there is an implicit accumulation of funds by the firm in order to cover these benefits. From this point of view, the firm (or, more specifically, the firm's management) acts as an agent of the employees for the monetary benefits that they are accumulating and entrusting to the care of the firm.

The factors that cause non-wage monetary benefits to be cited in bankruptcy claims are very similar to the factors that cause taxes, unemployment insurance premiums and other amounts owed the State (although collected and administered by the firm) to also be implicated in bankruptcy claims. This situation is due partly to faulty accounting practices and partly to the fact that employees or the State do not demand sufficient guarantees from their agent (i.e., the firm's management). A protection program that covers claims resulting from this lack of control over the

management of accumulated employment benefits is unlikely to lead to corrective action when conditions of employment are settled.

In order to avoid abuse of the new protection fund and to put a limit on its outlays, the CCA reform proposal, as well as the report of the Advisory Council of Adjustment, suggests that employers remain responsible for the sums paid out by the fund. However, the question of how to formalize this responsibility for employers is not spelled out.[6] The only measure put forward specifically to restrict abuse is the proposal that claims against the fund be reimbursed at 90 per cent ("a 10% deductible") to encourage employees "to seek payment of wages in full from their employers rather than to rely on payment out of the program."[7]

The 10 Per Cent Deductible As Control Measure

By definition, an insolvent firm is unable to meet its obligations, including the payment of wages to its employees. Using a 10 per cent deductible to encourage employees to seek full compensation from their employers is, in practical terms, the same as encouraging them not to tolerate any delays in pay cheques. Yet, looking at the options open to employees of insolvent firms, it is unlikely that a 10 per cent deductible would have the desired effect.

The choice facing the employee of an insolvent firm is rarely between keeping his present job without wage arrears and keeping it despite wage arrears. The usual situation is a choice between keeping his present job despite wage arrears and quitting before wage arrears occur. Therefore, the yardstick for predicting employee behaviour under a protection program is not the employee's full salary in his present job but rather his income if he leaves his present job. The trade-off in his decision is thus between his expected income should he quit his present job and the level of income he is likely to earn if he stays in his present job.

Unemployment insurance offers a temporary income equal to 60 per cent of previous employment earnings, up to a certain maximum. Because the UI program plays such an important role as a source of replacement income after a job loss, this program represents a valuable benchmark for assessing the incentives that the proposed protection fund would present in the current institutional context.

The proposed protection scheme would provide payments to replace employees' unpaid wages even if they remained on the job without receiving pay. The percentage of this replacement payment would exceed the income these individuals could hope to receive if they quit their jobs to collect unemployment insurance by at least 30 per cent of their employment earnings; thus it

would encourage employees to remain in their jobs until the amount of unpaid wages reached the fund's ceiling of $2,000.[8] Consequently, a 10 per cent deductible would be unlikely to restrain payments from the fund below the estimated $50 million mark. Moreover, this deductible would provide no guarantee that the protection plan would not delay the necessary economic adjustments (i.e., that it would not impede the reallocation of resources to other activities where the economic value would be enough to cover the costs involved).

An Alternative Solution

The parallels between the proposed protection fund and the unemployment insurance program actually go further than indicated in the above discussion. In fact, these two intervention mechanisms are very much alike, and their similarities suggest another approach to the problem of employee creditors of bankrupt firms.

In essence, the unemployment insurance program offers a form of wage insurance. One of the conditions for benefit eligibility is availability for work -- i.e., the applicant must not be working, whether or not he is being paid. In addition, the total amount of benefits is reduced if the employee concerned left work of his own volition. The proposed protection fund for employee creditors also constitutes a form of wage insurance against wage

loss due to employer insolvency. This eventuality is not covered by unemployment insurance because the worker is holding a job and so is not available for work.

Thus a form of protection for employees of bankrupt firms could be created by making the following change in UI eligibility requirements: employees of a bankrupt firms who fail to receive wages as they fall due would be entitled to file for unemployment insurance. In other words, *the primary criterion of benefit eligibility would no longer be loss of employment, but loss of wages.* This measure should encourage adjustment through the active involvement of employees. The filing of a claim would serve to sound the alarm when there is any delay in wage payment.

Under such a program, employees would have the option of remaining in jobs with outstanding back wages for as long as they wished. Wage arrears are an indication that the value of the firm's activities is insufficient to cover the cost of the resources allocated to it. Employees would be free to act on this indication by leaving the job after the first missed pay cheque to search for another, or could choose instead to let back wages accumulate in order to give the firm a chance to get back on its feet. The UI program should end up paying out much less than a wage-earner protection fund.

The protection fund or the expanded UI program could be financed almost entirely by higher UI premiums or through the government's consolidated fund. Even though under the proposed protection scheme employees reimbursed for wage claims from the protection fund would become ordinary creditors, the results of the survey cited earlier reveal that the recovery rate for ordinary claims, which would be looked after by the fund, is only 1 or 2 per cent, on the average, and in the majority of cases is zero.

Although the proposed compensation mechanism would be retroactive, it can be considered a subsidy paid to the debtor firm. Once the mechanism is in place, with established rules regarding the maximum number of weeks for wage claim eligibility, its existence will enter into decisions regarding firms in financial difficulty, since it will represent a possible source of wage payments.

An expanded unemployment insurance program would be compatible with the principles ideally guiding adjustment policies.[9] In fact, it is a dynamic application of these principles, since by offering the above slate of choices to employees, the expanded unemployment insurance program would allow the resource allocation process to tap into employees' inside knowledge about their firms.

5 ORDER OF PRIORITY

OBSERVATIONS ON CURRENT PRACTICE

The Bankruptcy Act groups creditors according to the priority order of their rights over the assets of an insolvent firm. The manufacturing sector survey used essentially the same as classification system as in the Act, although some homogeneity in the economic role of agents was acknowledged; for instance, financial institutions were grouped together.

According to the data collected by this survey, about 70 per cent of the total amount of secured debt, on the average, is held by financial institutions. Another slice of just under 10 per cent is held by governmental financial intermediaries (such as the Federal Development Bank). Virtually all the rest is held by suppliers and other creditors (residual category). Excluding governmental financial intermediaries, governments (primarily the federal and provincial ministries of revenue) hold scarcely 1 per cent, on the average. For ordinary debt (i.e., non-preferred and non-secured), the relative representation of financial institutions and suppliers is essentially the reverse of the secured-debt situation. The survey suggests, therefore, that secured debt is associated primarily with financial institutions and ordinary debt with suppliers. This correlation does not always hold, however.

The producer of a large piece of machinery or a new building may supply this asset on credit in anticipation of future gains. In this case, he is considered to belong to the "supplier" category of creditor. Given that the equipment provided to the firm is a durable good that can easily be identified, it represents an asset that could be used as a security; in the present context, this would be to the benefit of the creditor supplier. The survey in fact noted a few cases of a supplier holding such a secured debt.

The subject of commercial reorganizations is one of the items included on the agenda of recent reform proposals. The term "commercial reorganization" has never been precisely defined. Judging from the various reform proposals, the term appears to mean that the firm is able to survive in one piece beyond its state of insolvency. The sections of the Act targeted for revision in this area are those designed to encourage the adoption of proposals; the term "commercial reorganization" is used to refer more or less to the result when this procedure is invoked.

The findings of the manufacturing sector survey throw some light onto the association between proposals and reorganizations, on the one hand, and the survival of temporarily insolvent firms in one piece, on the other. The proposal option is not the only procedure provided by the Bankruptcy Act that can lead to the

survival of a firm such as a factory or other production centre in one piece.

The survey uncovered cases where assignments of property and receiving orders allowed temporarily insolvent firms to survive. On the other hand, there were a number of proposals that ended in the liquidation of the assets of the firm involved. This indicates that the eventual fate of insolvent firms' assets provides no basis for reforming the provisions of the Act with respect to proposals.

The distinguishing feature of proposals compared to other legally sanctioned procedures is not so much the disposition of the insolvent firm's assets, but rather the parties involved. Both the latest CCA proposals and the Colter Report refer to the insolvent debtor, who is empowered to negotiate a reorganization plan; the Colter Report also makes reference to the firm's owners. For all practical purposes, however, once a receiving order or assignment has been issued, the firm no longer has either debtors or owners.

FIRMS AS PLACES OF ASSOCIATION AND EXCHANGE

Prices and Rules of Conduct

All creditors of a particular firm, no matter what category they belong to, are participants in a common enterprise. In one sense, this enterprise can be considered a place for association and exchange, or a medium for profiting from exchange.

Human society has long provided a variety of such places, both institutionally and geographically. For example, a fruit and vegetable market offers local growers the opportunity to assemble in one place to sell their fresh produce. Among the various places of exchange, what is it that sets firms and commercial enterprises apart?

When the resources required for a particular project are considerable, a single individual does not have access to all the required resources or else is unlikely to allocate all the resources under his control to one project with uncertain results. An association or exchange among a number of parties becomes necessary. The first question to settle is the terms of this association or exchange. Although the resources involved have well-defined prices (in most cases), the crux of the question remains who will bankroll their purchase or who will supply them directly on a credit basis.

The parties willing to commit resources to the project in the prospect of future gains are bound together by terms of association, which are not well-defined prices. The profits to be derived from a particular project cannot be known in advance. The lack of well-defined prices makes it necessary to find a complementary basis of exchange for the parties involved in the enterprise. The Bankruptcy Act and other legislation governing business practices prescribes rules of conduct that serve to link the various parties involved in a project or enterprise. These rules and this legislation can be seen, from the economic point of view, as a substitute for the lack of well-defined prices because of uncertainty about the final outcome. Thanks to these laws, the uncertainty linked to the behaviours of the other people involved in the enterprise is reduced (to a degree).[1]

Secured Credit and Firms' Autonomy

The historical origin for the use of secured credit by creditors can be traced to the practice of pledged loans, which dates back to time immemorial. In common usage, a pledged or secured loan involved two clearly defined parties: a bank or individual creditor and a individual debtor. A degree of confusion has arisen with the use of this term in business loans and project financing.

From a financial perspective, a firm is composed of individuals pooling their resources in the prospect of future gains. Thus they are all creditors in a common enterprise carried out by the firm. The notion of debtor as used in traditional pledged loans is not applicable here, since all the parties involved have the status of creditor.

The debtor itemized in the firm's books under liabilities refers to a temporary debtor, a fictitious debtor that is above all the servant of the creditors. The function of debtor to a firm is instituted through the contracts that link a variety of creditors to a single project, through the division of responsibilities for managing the project (inherent in such contracts), and through the legal framework established to facilitate the association of a number of parties for the purpose of a single project. Yet the debtor remains above all a contractual or legal fiction, created to make it easier for a cast of different and sometimes changing individuals to participate in a common enterprise. When all these parties gather together, for instance in a case of insolvency in bankruptcies, the fictitious debtor has no real meaning.

Because the management of a firm is primarily the agent of all the firm's creditors (although it sometimes ends up in a debtor role), there is little to be gained by examining the use of secured credit in business from the point of view of the

creditor-debtor relationship. All creditors of a particular firm effectively exchange immediate access to resources for future gains. Prior to the delegation of authority by the partners in a firm to its management, however, it is more accurate to speak of an association between creditors in a single project. To the extent all creditors are not secured, holding a secured claim is to the creditor's advantage. The rationale for secured credit therefore, must be sought in terms of the individual contributions of creditors to the firm.

The project or projects of a firm can be said to develop and evolve over time. As the environment changes and decisions are made in light of these changes, the nature of projects and of the firm itself changes. For a creditor who has exchanged present access to resources for very long-term future gains, the evolutionary aspect of the firm to which he is associated is more significant than for the very short-term creditor such as a supplier with 90-day credit terms. In the latter case, there is a span of only three months between the assignment by the creditor of his resources to the firm and the maturation of his investment. If he is not reimbursed, there are steps he can take. Thus, there is a relatively short delay between the time he enters into an arrangement with the firm and the time he can take what steps might be necessary should the firm fail.

Aside from defaulting on payments, long-term creditors do not have the same ability as short-term creditors to react quickly to signs of weakness in the firm, since their investment does not mature for several years after they assign their resources to the firm. That is why special provisions are needed for long-term creditors -- to compensate for the disadvantages of their position relative to other creditors.

Long-term creditors are not the only creditors associated with a firm for an extended period of time. Stockholders in small- and medium-sized businesses without secondary markets for their investment securities are also in this position. There is a difference between creditors and stockholders, however. Creditors generally have no means of direct control over how a firm is managed and probably have little interest in its management; what the long-term creditor is seeking is a place to invest his money for a period of years.

Because long-term creditors generally have no power to influence a firm's management in the short term, the firm enjoys greater autonomy than it would if the same amount of investment were being provided by a number of short-term creditors. Thus a long-term creditor's willingness to become involved with a project that includes other parties with short-term bail-out options will depend on prevailing arrangements to compensate for his relative vulnerability relative to other creditors should the

project fail. Thus the primary reason for using secured credit and other suitable substitutes is the mix of credit terms taken on by a particular firm.

There is a variety of legal measures that directly and indirectly help creditors to secure their investments, such as Section 178 of the Bank Act and a similar piece of Quebec legislation, the Loi sur les cessions de biens en stock. There are also security registration offices. Another example is the provisions of the Bankruptcy Act that stipulate separate treatment for secured creditors. The benefits of such legal measures become clear when we look at the situation of a firm whose financing derives strictly from short-term investors rather than from a mix of short- and long-term investors. Its freedom of decision would be restricted and its financing costs higher.

Such are the basic reasons for the common practice of using secured credit. It is important to remember that secured credit is simply a way to level the difference between long-term and short-term creditors investing in the same business operation. Secured credit, therefore, is not a principle, but a practice, *and the legal measures designed to facilitate its use fall into the same category.*

Bankruptcy Act Versus Secured Credit

The basic mechanism of credit is the exchange of immediate access to resources for future gains. Secured credit relies on contracts containing special clauses that stipulate the available means of recourse should these future gains not materialize. From this perspective, the Bankruptcy Act offers a standard means of recourse that is explicitly provided by legislation when the parties to a contract have not specified other legal means of recourse (provided by legislation governing contracts, obligations, trusts, etc.).

In order for the Bankruptcy Act to be invoked as a means of recourse by unsecured creditors, a state of insolvency must exist. The circumstances in which secured creditors can invoke their means of recourse can be less restrictive; for example, if the pledged asset is not adequately maintained.

The extended contract inherent to unsecured claims combined with the present provisions of the Bankruptcy Act constitutes a form of collective recourse. Although the Bankruptcy Act is invoked by a single individual, all unsecured creditors will be directly affected by this action. In contrast to a collective recourse, a secured claim represents essentially an individual means of recourse.

As long as not all creditors are secured, a guarantee is a distinct advantage for the creditor, no matter whether his investment is large or small. Studying the nature of this advantage, however, will shed no light on why certain investments are secured and others are not. What can be instructive is the constraints governing the application of the guarantee. The survey provides information on the nature of secured debt and so provides some indication of how these constraints originated.

The survey revealed that there are relatively few secured creditors compared with unsecured creditors. In the survey, the sum total of debt was distributed just about equally between the two groups, but the average single amount of secured loans was significantly higher than that of unsecured loans.

Twin Principles of Conservation and Exclusion

All secured credit is guaranteed by one or more assets of the firm involved. An asset used to secure one loan cannot be used to secure another loan of the same type. Once a secured investment has been made, therefore, the assets of the firm involved may be divided into those used to guarantee loans (and possibly to provide a means of recourse) and those that are not. Thus secured credit is based in part on the principle of exclusion.

A loan is a contract over time; exclusion over time thus implies that the pledged asset maintains its own identity. So the exclusion principle leads naturally to another: the principle of conservation. The twin principles of conservation and exclusion may come into conflict with the role of the firm.

The function of a firm is to transform resources acquired elsewhere into a good or service of greater value. Even though the various services acquired by the firm -- from labour to transportation to accounting -- contribute to building the firm's assets, they do not maintain a distinct identity among these assets. Similarly, raw materials and intermediate goods, in contradistinction to buildings or capital equipment, do not maintain a distinct identity, except for their brief period in the supply inventory.

The fact that there are limitations involved in dividing a firm's assets into groups maintaining a distinct identity over time is likely a factor in the observed correlation between large loans and secured status. In the particular case of inventories (and keeping in mind the advantage that a guarantee confers upon an individual investor), the firm may find it advantageous, in certain instances, to offer its entire inventory of goods as collateral to an investor willing to commit a comparable volume of resources.[2] Moreover, accounts receivable are derived from the sale of goods in inventory, meaning that the first is simply

an extension of the other. In practice, therefore, a guarantee extended on goods in inventory will also include accounts receivable.

PROPOSED REFORM PACKAGE

Rights of Secured Creditors

The Bankruptcy Act in its present form does not impinge upon the rights of secured creditors; by default, these rights take precedence over those of other creditors. The amendments recently proposed by Consumer and Corporate Affairs comprise a five-point regulatory plan. First, secured creditors or their agents (receivers) would be explicitly bound to act in good faith in taking possession of the assets of an insolvent debtor and would be subject to the authority of the court in this regard. Second, receivers would be required, within ten days, to inform the Superintendent and other creditors of their appointment, the amount of the claim, and the nature of the security.

Third, in the case of commercial loans, the secured creditor would be required to give the debtor ten days' notice before acting to seize an asset, and to forward a copy of such notice to the Superintendent. The purpose of this measure is to "prevent precipitous liquidations of businesses" and to "provide debtors with the opportunity to begin commercial reorganization

proceedings."[3] Fourth, at the request of the debtor, a creditor or a trustee, the fees charged by a receiver could be submitted to the court for approval.

The fifth point discussed with regard to secured creditors and seizures is the possibility of conflicts of interest. A set of eligibility requirements for trustees and receivers is proposed in order to eliminate or reduce such conflicts.

The proposed amendments do not aim to change the priority of secured creditor rights from present arrangements. However, these amendments could lead to delays in the exercise of these rights over a pledged asset, thus adversely affecting their eventual net value. Further, the measures proposed for commercial reorganizations, particularly with respect to secured creditors, may increase the likelihood of this happening.

Reorganizations

One aim of the proposed amendments is to encourage the acceptance of reorganization plans included in proposals and to extend their application to secured creditors (or certain categories of secured creditors). Five changes are proposed. First, an insolvent debtor would have the option of filing a notice of stay with the Superintendent to freeze the proceedings of both secured and unsecured creditors for a period of 30 days,

renewable for an additional 21 days following the filing of a reorganization plan. In order to protect the interests of creditors, the interim receiver named in the notice of stay would be empowered to take action as might be necessary and "to exercise any powers that the Court deemed fit for the administration and protection of the debtor's estate." Second, the reorganization plan would apply not only to unsecured creditors but also to certain secured creditors as named by the debtor, this latter choice to be ratified by a vote.

Third, new voting procedures are proposed. The secured creditors affected by the reorganization plan would vote by class. A plan, once accepted, would be binding on all creditors in a given class, and the grounds for acceptance, for both unsecured creditors and the various classes of secured creditors, would be a majority of creditors holding claims representing 2/3 of the value of claims of voting creditors.

Fourth, it is proposed that Court approval of a reorganization plan be conditional upon the plan providing for immediate payment of all claims eligible under the wage protection program. Fifth, a series of measures are proposed to limit the exercise of certain rights that might adversely affect the success of a reorganization plan. These include the rights of public utilities, Crown rights, and executory contracts.

Current bankruptcy legislation allows an insolvent debtor to submit a reorganization plan. What is new in the proposed changes is that secured creditors may also be subject to such plans. If there is sufficient support for a given plan by a particular class of secured creditors, all secured creditors in this class will be bound by the plan. A proposal may therefore establish collective rights that supercede a creditor's right to appropriate a pledged asset.

Crown Priority

Under the current legislation, Crown claims constitute a special category of preferred creditor coming just after wage claims in order of priority. In addition, some government agents (departments, commissions, and so on) can make use of securities, giving them rights similar to those of secured creditors. The first amendment proposed by the CCA in this area is to abolish the Crown's status as preferred creditor. Other amendments are designed primarily to formally standardize the use of secured credit by various government agents (for example, the registration requirement that is applicable in certain cases and not in others). Second, it is proposed that the secured-creditor rights of government agents responsible for legislation and programs in the areas of income tax, unemployment insurance and the Canada Pension Plan be suspended for a period of up to six months once a proposal is approved. The aim of this amendment is

the same as the proposal under reorganizations. The remaining amendments are designed primarily to ensure fairer treatment for the claims of other creditors.

Suppliers

Given the unfair situation faced by suppliers in bankruptcy cases, it is proposed that they be allowed to retrieve delivered merchandise or its equivalent monetary value. No specific measures are put forward, however.

ASSESSMENT AND AN ALTERNATIVE

In its present form, the Bankruptcy Act is designed to regulate the behaviour of all creditors, except secured creditors in cases of bankruptcy. The proposed amendments are aimed at establishing the same kind of regulatory framework for secured creditors. In other words, the essential thrust of the proposed package is to maintain the distinct right of intervention for secured creditors in the Bankruptcy Act, but to establish better control over this right.

Some recent judicial decisions have invoked other legislation as a means of controlling the abuses that can arise when certain categories of secured creditors exercise their rights in a situation of insolvency. This is an indication that *the*

legislation as it now stands does not cover all of its area of jurisdiction. It is also worth noting that the original intent of the Bankruptcy Act is completely at odds with a distinct right of intervention for a particular group of creditors.

The value of all claims against a firm is based on the same collection of assets. The possibility that a particular category of creditors can seize part of these assets undoubtedly affects the behaviour of creditors in other categories.

The advantages offered by bankruptcy legislation as a means of recourse stem from the fact that all creditors are bound by the legislation. As was previously noted, it is impossible to set a monetary value on creditors' contribution to a firm, primarily because of the possibility of insolvency or bankruptcy. By imposing a number of rules of conduct, the legislation ensures that there is a substitute for the lack of a defined price, so that the range of possible outcomes is restricted enough that potential investors will find the project attractive. According a special right of intervention to a particular subgroup of creditors in a situation of insolvency significantly reduces the value of this substitute.

The main concern of a secured creditor instituting individual action in a case of commercial bankruptcy is to recover his investment. It is only logical that he is not much concerned

about the value of assets as a whole. Yet a particular asset can be worth much more as part of total assets than alone. This would be true of a large, highly specialized piece of equipment, for example. The power of one or more creditors to take action on an individual basis makes the situation of other creditors all the more precarious, especially considering that all creditors do not become aware simultaneously that a firm or project has failed and become insolvent. The surest indication of insolvency is non-payment of an amount due, and payment dates vary from one creditor to the next. As long as creditors are not all governed by a single system, this circumstantial isolation will remain a source of uncertainty that adversely affects the value of the legal option.

More specifically, the essential advantage of a procedure that is binding upon all creditors is that the gains derived by each creditor from the bankruptcy become mutually dependent. All parties involved have good reason to subscribe to procedures that will resolve the insolvency so as to maximize the value of assets as a whole under the circumstances. *The proposed amendments*, since they perpetuate two distinct systems, *will not have the same advantages as a single-procedure system*. Among other things, the value of the remaining assets for ordinary creditors is left to chance, or more accurately to the mercy of the mood of secured creditors.

It was observed earlier that long-term credit, without being a justification for particular practices, can provide a rationale for the use of guarantee. The proposed reform implicitly assumes that it is impossible within a single procedure that is binding upon all creditors to provide fair treatment for long-term investments. However, because of its simplicity and implicit recognition of the workings of long-term investment, the "first in, first out" (FIFO) rule -- in other words, the older the debt, the higher its priority -- can provide a guideline for deciding the amendments needed for an efficient Act that will avoid the numerous pitfalls of the distinct intervention right.

The means of control provided by the present legislation to ensure that the treatment of an unsecured creditor in a situation of insolvency or pre-insolvency does not adversely affect the other parties involved appear to be generally adequate. Thus an excellent way to eliminate abuse on the part of all creditors would be to broaden the scope of this control, since it has been proven to work well. In addition, the application of the FIFO rule would serve to head off the scrambling among creditors to secure their claims, which is not unlike the inefficient competition that prevailed in the days before bankruptcy legislation, when creditors vied against each other in the race to seize the assets of an insolvent firm. This scramble for guarantees is all the more inefficient because so often the guarantee does not have any real basis or justification -- as is

the case, for instance, of guarantees associated with call loans, which carry the shortest possible credit term.

The long-term creditor is particularly vulnerable. The proposal to replace the distinct intervention right of secured creditors is not simply an application of the FIFO rule, but involves supplementing this rule with optional clauses included in contracts between long-term creditors and the firm's other investors. Such clauses would stipulate a set of conditions under which long-term creditors would be entitled to an earlier-than-usual reimbursement of their investment, with receivership left as a means of recourse. Given these new legal advantages for long-term creditors, the term of a prematurely called loan would remain in effect after the reimbursement for the purposes of the Bankruptcy Act in order to make sure the borrower is still able to access other sources of financing should a long-term loan be called in early. This would allow the status of long-term investor to be transferred retroactively to another creditor for the balance of the term.

Suppliers of Goods and Services

In implementing FIFO priority, it is important to recognize the special circumstances of wage-earners and other suppliers of goods and services. Because the credit held by these partners in the firm is very short-term, they have the lowest priority under

this rule. As discussed earlier, the reason wage-earners and other suppliers are considered creditors is not because they act as investors or financial intermediaries, but because they provide services or merchandise on credit, to be subsequently paid at specified times in accordance with quantities used, a practice that greatly simplifies transactions and reduces administrative overhead.

In the same way as it is part of the investor or financial intermediary's job to take the time and effort to evaluate the financial situation of their debtor, it is up to suppliers to determine the particular needs of their clients in terms of goods and services. Thus task specialization can be of benefit here, since it can avoid overlaps in the resources used to meet two types of needs: financial needs, and goods and services requirements. To achieve such a specialization of tasks, *it would be better to ignore the priority rule based on supplier's credit terms. Thus suppliers would have priority over other creditors in the distribution of property from a bankrupt firm.*

A supplier claim would be defined as a claim originating from the sale of a good or service on credit for which the period between the issue of the credit and the date of bankruptcy falls within a certain limit fixed by the Act -- this could be 90 days, in accordance with the credit period for commercial transactions. Beyond this period, business claims would be subject to the FIFO

rule like all other claims. Instituting such a time limit and granting conditional priority to supplier claims would appear to be the best way to encourage task specialization.

The fact that a supplier creditor could not extend his claim longer than a few months without losing his priority status would discourage him from acting as a financial intermediary in the absence of incentives to adequately fulfil this role. His priority status alone would not provide enough incentive for him to monitor the financial situation of his client closely and to act in an expeditious manner. With prioty status given to suppliers, a supplier who has the option of doing business with new clients would generally not feel it necessary to worry about their financial position. Moreover, if the amount of goods or services required by a new client is substantial, the financial institution involved will become a reliable source of information on the client, since, with priority given to suppliers' claims, financial institutions will benefit from their involvement only to the extent that it contributes to the business's success.

The legal framework outlined here as an alternative to the proposed reform package will serve to make the financial institution credible to suppliers and to open a market for the information that this institution possesses. This is not true under the present legal framework nor under the CCA's proposed system, since as soon as a financial institution obtains a

guarantee, its interests necessarily diverge from those of the suppliers. In fact, it becomes to the financial institution's advantage that suppliers assume the risk of losses as a result of their involvement in businesses in difficulty, because their losses directly contribute to its dividends from bankruptcy.

Commercial Reorganizations

Priority order based on the elapsed term of the claim and an understanding that suppliers' motivation for extending credit is commercial rather than financial would also help to bring about more efficient treatment of the matter of reorganization.

The overt aim of the recommended changes to the proposal procedure is to make it easier for businesses in financial difficulty to survive intact. As noted earlier, the procedures currently provided by the Act can achieve this result. In practical terms, the proposed amendments would facilitate the approval of reorganization plans and give the plans, once approved, greater authority over all parties involved, particularly secured creditors.

If the proposal procedure, in contrast to the liquidation procedures contained in the Act, cannot be conceived in terms of a particular allocation of the specific assets of an insolvent business, in what terms can it be conceived? The difference

among the various procedures provided by the Act lies in the rights and responsibilities of the various parties involved in the firm; assignment of property and receiving orders represent procedures by which creditors assert their claims over the remaining assets of an insolvent business by suspending the managerial autonomy of its officers or the debtor. The proposal, on the other hand, maintains partial managerial autonomy. Thus the proposed amendments should be judged on the basis of existing and potential incentives to creditors and investors.

An insolvent business is one that has failed to secure a resource flow sufficient to meet its financial and other obligations. It is not simply that expenditures exceed revenues, since businesses can make large investments relative to their size and be placed simply in a deficit position, not insolvency, as long as there are creditors and investors willing to give them access to sufficient resources. Business insolvency, therefore, can be viewed as a refusal by present and potential creditors and investors to extend new resources to the business.

Part of the reason for such a refusal may be an excessive debt load that makes the potential gains of creditors and investors very small, even nil. Yet a business may still have assets that can generate some future gains. The new resources needed to maintain and utilize these assets can only be found if existing creditors agree to reduce the size of their claims. There is no

incentive for one or a handful of creditors to do so. The purpose of a procedure like the proposal is to provide the business's creditors as a whole (or their delegated representatives) with the opportunity to make joint decisions on the reduction of their claims.

The primary obstacle under the present system to general creditor decisions on the value of claims is secured credit. This practice causes two problems. First, secured credit allows a creditor to exempt himself from legislation designed to affect all creditors equally. Thus the creditors are no longer a unified body, but a series of subgroups. Second, a secured claim in a case of insolvency can be reimbursed without regard to the value of remaining assets for unsecured creditors. *Thus there is no common basis for negotiation between secured and unsecured creditors on reducing the value of their claims.*

Most of the problems targeted by the amendments in the CCA reform package could be solved by instituting priority order based on the elapsed term of the claim, rather than on secured claims, as well as a distinct intervention right for secured creditors. The amendments as proposed tend to bias the application of the Act in favour of the approval of reorganization plans. This runs counter to the principles of efficiency discussed in Chapter 3, which state, notably, that agents' preferences and constraints should be the sole

determining factors in the approval or refusal of such plans. The alternative explored here -- priority order on the basis of terms and special status for commercial creditors -- conforms to these standards of efficiency. This solution, in fact, would encourage the parties involved in a business to make use of all the information available instead of trying to work against the best course of action on the basis of this information.

The alternative solution proposed herein would involve a few minor changes to the current proposal procedure in order to make the process simpler. One of these would be to institute a single-vote system for creditors and to make approval of a plan contingent solely upon a special resolution requiring only a three-quarter-value majority. Such a procedure would provide adequate protection for long-term creditors.

If a business has expanded significantly since a loan was granted, the relative importance of a long-term creditor relative to the other creditors will have fallen in equal measure, and the vote he casts against a reorganization plan will carry less weight. Another consequence of this situation is that the business will have acquired access to additional resources since the loan was granted; under a term-based priority system, the probable value of the long-term creditor's claim would have risen proportionately. If he is still bound to a reorganization plan against his will by a special resolution of the type proposed, it

is clear that the plan enjoys widespread support. Thus, since terms can be transferred to another creditor, he should have little difficulty in selling his claim.

The incentives provided by the use of proposals illustrate the advantages that the alternative approach developed above would offer to financial intermediaries making long-term commitments of resources to businesses. This is certainly a worthy goal. While long-term creditors are the most vulnerable of all creditors, the type of financing they provide is critical for businesses (particularly small businesses) wishing to launch new projects.[4] Thus it makes good sense to assist long-term creditors by applying the FIFO rule and giving them the right of priority transfer.

In order to protect the status of suppliers when the proposal procedure is invoked, the priority given to commercial claims would be guaranteed for a new 90-day period starting from the date of approval of the reorganization plan. This provision, as well as those made earlier granting special status to commercial claims, conforms to our principle of efficiency. Despite their priority in assets distribution, suppliers would have no reason to oppose a reorganization plan as long as the difficulties faced by the business were only temporary, since they would then be foregoing future sales for the immediate payment of a previous sale. Under the proposed system whereby their priority would be

temporarily suspended, suppliers would have every reason to trust those most knowledgable about the business's financial situation, i.e., its long-term creditors and financial intermediaries. This will produce a bankruptcy system in which those parties with the best information will have both the power and the incentive to allocate assets so as to maximize their value.

Crown Priority

It remains to discuss the amendments proposed by the CCA for crown priority. As was the case for those related to commercial reorganizations, the primary objective of the proposed changes, besides formalizing the use of secured credit by government officers, is to facilitate the adoption of reorganization plans, notably by extending the deadline for Crown claims by several months. Here again, *the effect of the proposed amendments would be to introduce a bias in favour of the use of proposals, not to increase the procedure's efficiency.*

There are several reasons why the Crown should not be a source of business financing. The most basic objection is that unpaid Crown claims are especially prone to inefficiency and abuse. More than any other type of financing, the amount of taxes collected by a business as a Crown agent but not forwarded to the Crown escapes the control of investors or financial

intermediaries, whose function it is to allocate savings to projects bringing the best possible exchange value.

In the present context, a tax relief can be considered a form of saving, and Crown claims left unpaid become a source of financing; these encroach upon the territory of investors and financial intermediaries. The inevitable result is wasted resources and a general impoverishment of performance incentives. *Any and all recourse to the procedures provided by the Bankruptcy Act should guarantee priority reimbursement of Crown claims; in the case of proposals, the implementation of a reorganization plan should be contingent upon such a reimbursement.*

This proposal, in combination with that awarding temporary priority to commercial creditors, supports the central role played by investors and financial intermediaries in the allocation of savings. In order to safeguard their area of expertise, commercial creditors and the Crown (except when acting as a financial intermediary) should be barred from these activities.

Measuring Efficiency Gains

There are two ways of looking at this question: we can speak either of the efficiency gains resulting from the replacement of the current Act by more efficient legislation, or of the

resources wasted by having legislation that is less efficient than another option. Economic agents act as the primary judges of legislative reform by mutually agreeing whether to play or not by new rules. Still, studying the extent of gains or waste can give some indication of the true stakes of legislative reform. If losses are minimal, the laborious process of legal reform is not worth undertaking. Conversely, if losses are significant, there is more justification for initiating the reform process.

For a number of reasons, it is very difficult to calculate efficiency gains directly; in the present instance, the main problem is that the two situations we want to compare cannot be directly observed. Failing direct calculation, best-guess estimates of the maximum and minimum values of these gains can still be useful. If the estimated maximum is quite low, gains too will be low, and there will be little justification for undertaking reform. If the estimated minimum is quite high, the gains should be high as well, and reform will likely be worthwhile. If the estimated minimum is quite low, no conclusion may be reached one way or the other, while if the estimated maximum is quite high, we can conclude that the estimated values do not provide any grounds for rejecting the proposed alternative out-of-hand. The evidence presented below, given the available information, falls into the latter category.

The efficiency gains resulting from the implementation of more efficient legislation essentially derive from the elimination of waste that can be found at three levels: first, at the level of financial losses of creditors of bankrupt businesses; second, at the level of resources needed to register and realize secured claims; and third, at the level of resources taken up by the duplication of the financial intermediation function. There are several sources of duplication, including the fact that suppliers have the option of dealing with wholesalers rather than directly with the firms buying their goods and services.

The financial losses of creditors of bankrupt businesses are equal to the exchange values produced by the firms involved minus the cost of resources allocated to them. Reallocating the amount of these losses to consumption expenditures would lead to proportional increases in welfare. These losses (which totalled approximately $4 billion in 1989) cannot be attributed entirely to resource waste due to legislative inefficiency; no matter how efficient the legislation, waste cannot be eliminated entirely.

Creditors' financial losses may be divided into three components: "experimentation," which includes resources allocated to an unsuccessful (though inevitable and perhaps desirable) search for better ways to fulfil existing needs; "inefficiency," losses resulting from inefficiency in legislative

incentives; and lastly "consumption by debtor parties," also stemming from legislative inefficiencies.

The "inefficiency" component would become evident with the institution of new, more efficient legislation providing for greater control by creditors and earlier intervention in the affairs of bankrupt businesses. The third component consists of inputs that are absorbed by management rather than entering in the production of exchange values that can reduce creditors' losses. Although this "consumption" component contributes to the welfare of existing agents, it is still something to be avoided. Thus the "resource waste" portion in creditors' total financial losses is covered by the second component and, to a large extent, by the third component. The fact that there is room in the present legislation for substantial improvement in incentives suggests that these two components are not negligible. But even though the "experimentation" component could account for as much as 90 per cent of creditor's financial losses, the remaining 10 per cent, representing resource waste, would represent a very substantial amount -- around $400 million in 1989.

The resources expended by commercial creditors on registering and realizing secured claims can be measured by studying the operating budgets of registry offices and the income and expenditures of receivers. The resources involved, while likely

smaller than the above amount, are still positive and significant.

A supplier who furnishes small quantities of goods or services to a large number of firms cannot afford to keep constant tabs on their respective financial positions. For a wholesaler handling several product lines, however, sales to his various clients may be large enough to justify the cost. The amount of resources consumed by wholesale operations in 1985 was $20.5 billion, close to 4 per cent of gross domestic product. Thus the portion of these resources potentially going to financial intermediation, even though quite small, could amount to a considerable sum. Because current legislation does not encourage financial institutions to provide suppliers with the kind of information they need to minimize their losses and because suppliers account for almost all the commercial creditor losses cited above (close to $4 billion in 1989 alone), it is reasonable to suggest that, over the years, the wholesaler has in some cases assumed some financial intermediary functions.[5]

In light of these considerations about the levels of efficiency gains that could be realized with the institution of legislation offering more efficient incentives, there seems to be no reason for opposing reform of the present Act in this direction.

6 CONCLUSION

The most recent proposal for reforming the Bankruptcy Act tabled in the House of Commons bears some similarity to previous proposals, although its objectives are somewhat more limited. In addition to recommending the creation of a wage-earner protection fund, the latest proposal aims to regulate the behaviour of secured creditors at the level of both business liquidations and reorganization procedures, while maintaining their distinct intervention right. After studying the basic principles of secured financing and discussing the purposes of the various debt categories and the Act's role in the pursuit of enterprises, the present paper comes to different conclusions with respect to the principles and content of the reform package that it would be advisable to table in the House of Commons.

On the subject of employee wage claims, this paper proposes making minor changes to the unemployment insurance program rather than setting up a special protection fund. Beside being less costly, this alternative also has the advantage of not impeding adjustment and reallocation of resources to more productive jobs. Regarding the practice of secured credit for business loans, the paper proposes substituting a modified version of the "first in, first out" principle, and recommends that the Bankruptcy Act be brought back to its original purpose -- to be the means of recourse for *all* creditors should the firm in which they have

invested end up in bankruptcy. Extending the application of the Bankruptcy Act in this way to the full range of its jurisdiction would involve only minor changes to its present provisions regarding standard bankruptcy violations (e.g., preferential payment) and reorganization procedures.

The main modifications to the "first in, first out" rule would concern claims by suppliers and the Crown. The claims of suppliers of goods and services (or commercial claims) are not the result of financial intermediation but rather of an effort to minimize the administrative overhead involved in commerce and exchange. In order to eliminate the financial losses associated with this type of claim, as well as the duplication of financial intermediation that these losses tend to generate in certain cases, commercial claims would be exempted from the "first in, first out" rule and given top priority, subject to conditions to verify their strict commercial character. For similar reasons, Crown claims would also be exempt from this rule and would always take precedence over all other claims.

NOTES TO CHAPTER 1

1 The classification of adjustment policies used here was introduced by the Economic Council of Canada in its statement on adjustment (*Managing Adjustment: Policies for Trade-Sensitive Industries*, 1988).

NOTES TO CHAPTER 2

1 Among the changes introduced by the 1949 bill was the possibility for an insolvent person to make a proposal without going through the procedure of bankruptcy. The 1966 Amendment gave greater power to the Superintendent to investigate "fraudulent bankruptcies."

2 A "special resolution" means:

"a resolution decided by a majority in number and three-fourths in value of the creditors with proven claims present, personally or by proxy, at a meeting of creditors and voting on the resolution" (Section 2).

While an ordinary resolution requires a majority of votes with the number of votes given to each creditor being based on the value of his/her claims (1 vote for a claim within the range \$25 - \$200, 2 votes for a claim within the range \$200 - \$500, 3 votes for a claim within the range \$500 - \$1,000, for claims of \$1,000 and over, 3 votes and one additional vote for each additional one thousand dollars or fraction thereof) (Section 115).

3 Courts vested with first jurisdiction under the Bankruptcy Act are provincial Supreme Courts or similar institutions (in Quebec, it is the Superior Court of the Province; in Manitoba and Saskatchewan, it is the Court of Queen's Bench of the Province, etc.) (Section 183).

4 Bohemier, A. (1986), p. 10. Among the other implications of Article 43(2) is that a petitioning creditor who is secured must either give up his security or act as an unsecured creditor for the unsecured balance of his claim.

NOTES TO CHAPTER 3

1 Senate Debates, second session 1949, p. 97.

2 Canada, Debates of the House of Commons, 1919 session, Vol. I, March 28, 1919, p. 132.

3 Senate Debates, second session 1949, p. 98.

4 Canada, House of Commons, Standing Committee on Banking and Commerce, November 24, 1949, p. 14.

5 The 1946 bill, had it been adopted, would have also occasioned the repeal of other legislation, such as the Winding-Up Act (Senate of Canada, Minutes of Standing Committee on Banking and Commerce, May 28, 1946, p. 1). In the case of more recent proposals, the Farmers Creditors' Arrangement Act would also have to be repealed and about twenty other acts amended.

6 Ibid., June 20, 1946, p. 38.

7 Ibid., June 26, 1946, p. 90.

8 Brief presented on behalf of the Dominion Mortgage and Investment Association to the Standing Committee on Banking and Commerce (Senate), Minutes of the Committee, June 20, 1946, p. 61.

9 Canada, Standing Commttee on Banking and Commerce (Senate), Minutes of the Committee, June 26, 1946, p. 93.

10 Brief filed by the Board of Trade of the City of Toronto to the Standing Committee on Banking and Commerce (Senate), Minutes of the Committee, June 26, 1946, p. 116.

11 This summary of the most recent proposal for revising the Act quotes freely from the text of the proposal (Consumer and Corporate Affairs Canada, 1988).

NOTES TO CHAPTER 4

1 Or, from a more operational point of view, an organization that incorporates a number of management centres or firms, each specializing in certain tasks. For example, a personnel services firm is specialized in the selection and training of labour.

2 Employee status confers other monetary benefits that may increase the amount of wage claims. The proposals contained in the report of the Advisory Committee on Adjustment are more generous than those of Consumer and Corporate Affairs in that they recommend that, in addition to wage arrears, severance pay and other monetary benefits be included in a single claim.

3 Standing Committee of the House of Commons, May 28, 1984.

4 Compared to the effect of super-priority, Article 178(7) of the Bank Act is more restricted in application. Among all lenders that might be considered secured creditors, only banks are subject to the provision. However, through a trust deed, banks can obtain guarantees without being subject to this constraint.

5 J. R. Baldwin and Paul K. Gorecki (1989).

6 Aside from the fact that the employer is an agent of the firm's partners and creditors, including its employees, what regulation should serve to distinguish the usual circumstances surrounding bankruptcies from the responsibility of the agent-employer is not clear.

7 Report of Consumer and Corporate Affairs, p. 3.

8 The figure of 30 per cent represents the difference between the 90 per cent payable by the fund and the 60 per cent paid in the form of unemployment insurance benefits. This 60 per cent is a ceiling; in cases where employees' wages exceed the insured maximum, benefits will be lower than 60 per cent, and so the supplement offered by the protection program will be more than 30 per cent. The case of employees who are able, fairly quickly, to find a job paying at least 90 per cent of their former wages is not really relevant here, because, generally speaking, they have little reason to resort to a protection program by remaining in the service of an employer who is unable to pay them.

9 Refer, for example, to Chapter 8 in Economic Council of Canada (1988): "Principles for Adjustment in an Imperfect World," pp. 113-127.

NOTES TO CHAPTER 5

1 The kind of support enshrined in legislation for new commercial projects and businesses, as well as the vocabulary used in the legislation, sheds some light on the characteristics of a firm as a place of exchange. The limited-liability corporation represents a turning point in legal history. The purpose of this legal provision was to make charters more readily accessible; up to that point, they had been awarded only by the king on a case-by-case basis, similar to city charters (cities, too, can be considered places of exchange). The term "business venture" reflects the basic purpose of this legal instrument (originally a charter, but in modern times the limited corporation): to undertake a project requiring a certain

volume of resources and with an outcome that cannot be known exactly at the outset.

The limited-liability corporation is a legal instrument that helps set up a basis for exchange and create a place of association and exchange. One argument in favour of legal provisions designed to facilitate recourse to secured credit and other similar measures could be that they complement the limited-liability corporation by making the basis and place of exchange even more profitable. Generally speaking, corporation law and other related legal provisions prescribe a number of rules of conduct that are essentially substitutes for the terms of association or well-defined prices that are not available to the parties associated in a business venture.

2 Section 178 of the Bank Act serves to make it easier for a particular category of creditors (i.e., banks) to benefit from this practice.

3 Consumer and Corporate Affairs (1988), p. 7.

4 It was shown that the particularly heavy debt load carried by small businesses was primarily the result of very short-term borrowing.

5 Another way of verifying this theory, if the information were available, would be to compare the product lines associated with different bankruptcy rates among retailers and to see whether the relative importance of wholesaling in the distribution of these product lines varied directly with bankruptcy rates.

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