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Small Business Secretariat Working Paper

A STUDY OF THE CIRCUMSTANCES OF
SMALL BUSINESS INSOLVENCY



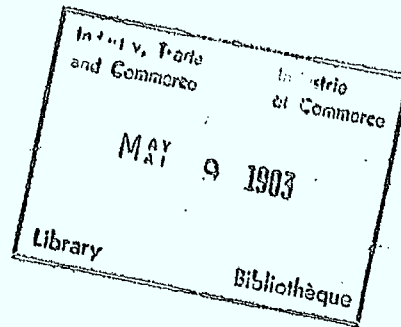
Government
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Industry, Trade
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Industrie
et Commerce

TRANSLATION



A STUDY OF THE CIRCUMSTANCES OF
SMALL BUSINESS INSOLVENCY

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of the Department of Regional Industrial Expansion
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Executive Summary

The objectives of this study of business insolvency are firstly, to determine the circumstances pertaining to bankruptcy and sequestration in 1981, and, secondly, to establish their cause. The methodology is based mainly on the selection of a sample of twenty-two (22) small businesses which went bankrupt or were sequestered in 1981. The case of each chosen business was studied and discussed with the appropriate trustee or insolvency officer and/or the bank official and the owner. In all, fifty-nine (59) persons were interviewed, including twenty-six representatives of the principal receivership firms in the Montreal and Toronto areas; twelve (12) representatives of the largest Canadian chartered banks; eleven (11) owners or managers of businesses which had gone bankrupt or were sequestered; and ten (10) representatives of various organizations, including the Canadian Bankers' Association, The Canadian Creditors Association for the Revision of Rights and Legislations, and the Canadian Federation of Independent Business.

While researching statistical data relevant to this study, we encountered a number of obstacles. Quantitative information on business insolvency does not consider sequestration. On two (2) occasions we attempted, without success, to compile statistics on business sequestration, first through the offices of the Quebec Insolvency Association, then through the Canadian Insolvency Association. Failure was due to a total lack of cooperation by the members of those two (2) organizations. The information on which government authorities base decisions affecting the Canadian economy should, in our view, be as complete as possible. Government intervention in this matter would be the quickest way to correct this deficiency.

It appears also, in the light of our brief analysis of Canadian economic life in the past few years, that the easy conditions for setting up business in the nineteen seventies are responsible for the growing incidence of bankruptcy. Following a period of expansion, when the attitude of governments, banks and the consumer encouraged entrepreneurial activity, Canada has now entered a much more difficult phase. Changes in governmental, bank and consumer behaviour have caused many a business to close its doors. An even greater number of bankruptcies and sequestrations is forecast for 1982.

The analysis of government policies on incentives to business leads us to conclude that there is a serious lack of co-ordination in the efforts expended to help small businesses. Good intentions, expressed everywhere by all levels of government, by creditors, and by banks, are not sufficient to ensure the best results. Moreover, a lack of continuity in the various programmes, inadequate publicity aimed at the parties concerned, and finally, inadequate follow-up are evident.

Lastly, we must conclude that the ultimate causes of business insolvency are attributable to poor management. The impact of high interest rates, the undercapitalization of small businesses or the saturation, artificial or not, of certain markets are not denied or overlooked. Nevertheless, it must be pointed out that while all Canadian businesses face the same financial and economic constraints, most manage to survive.

The behaviour of owners of small Canadian businesses is typified by their refusal to acknowledge their lack of management know-how and experience, their refusal to consider the value of the contribution that may be made by resource persons outside the firm and their rejection of options for association with private investors in order to improve capital structure and reduce their dependence on lending institutions. These are the major causes of the problems confronting small businesses in trouble in Canada.

Chapter 1

Introduction

There are about one million businesses in Canada, and 97% are small or medium-sized⁽¹⁾. Sales of over 100 billion dollars, 30% of the GNP and 40% of employment in Canada are attributable to these businesses⁽¹⁾. In the present period of economic recession, a great many businesses are in difficult circumstances and a number are in a position of insolvency. Given their impact on the Canadian economy it is understandable that this phenomenon attracts the attention of the public in general, and in particular of governments, banks, creditors and businessmen.

The Canadian government is certainly one of the agencies best able to respond to the needs of small businesses considered as economic units and to intervene on their behalf, if this were deemed profitable or essential to the Canadian economy. Our mandate, i.e. a study, for the Small Business Secretariat, of insolvency of businesses in Canada, can be summed up in the two (2) following objectives:

- To determine the circumstances attendant on bankruptcy or sequestration of small businesses in 1981.
- To define, as accurately as possible, the reasons for bankruptcy and sequestration.

The methodology used to attain these objectives is described in Appendix I of this paper.

Our study comprises three (3) main parts. First, we will analyse the present situation and thus achieve a quantitative and qualitative evaluation of bankruptcies and sequestration amongst small businesses in 1981. Second, a brief analysis of government policies in the light of national economic objectives and of the impact of these policies on small and medium-sized businesses will complete our study of the environment in which operate many of the businesses in financial difficulty. Third, we will determine the immediate and underlying causes of the bankruptcies and sequestrations.

(1) Source: Department of Industry, Trade and Commerce, "New Statistics of Small Business in Canada," 1979.

Chapter 2

2. Analysis of the Present Situation

2.1 Definitions

At the outset of the quantitative evaluation of the present situation it would be useful to define certain key terms repeatedly used throughout the study. It is especially important to avoid confusing business insolvency with business closure. Among the companies which halt their operations and close down there are, of course, some that are insolvent, but there are also many other reasons for the disappearance of firms from the scene. They include mergers, a sale of assets to other investors or even the owner's retirement.

We use the Dun & Bradstreet definition of commercial bankruptcy to distinguish what we call insolvent businesses. The reason that we do not use the same term as Dun & Bradstreet is that it is our intent to discuss insolvency rather than commercial bankruptcy, and thus avoid confusion with "legal bankruptcies" which are the result of assignment of a firm's property to its creditors under the laws of receivership.

According to Dun & Bradstreet the businesses designated insolvent include: "businesses that ceased operations following assignment, receiving order, or proposal; ceased with loss to creditors after such actions as execution, or foreclosure; voluntarily withdrew leaving unpaid obligations; were involved in court actions such as receivership, or arrangement or voluntarily compromised with creditors."

Finally, we define sequestration as taking possession of a company's assets by a secured creditor or creditors.

2.2 Quantitative Assessment of the Present Situation

2.2.1 Bankruptcies

As shown by appendices IV and VII, bankruptcies in Canada have increased from 2,976 in 1976 to 8,055 in 1981⁽¹⁾.

This is equivalent to a 22% annual increase⁽²⁾ for this five (5) year period. Close to 77% of the bankruptcies,⁽²⁾ as shown by

(1) Source: Dun & Bradstreet, "Study of Commercial Bankruptcies in Canada", Toronto, 1980

(2) Source: Office of the Superintendent of Bankruptcies, "Insolvency Bulletin", Vol. 2, No. 1 (1982).

Appendix VIII, took place in Quebec and Ontario. The sectors most affected were the construction, automobile, agriculture, fisheries, forestry, furniture, garment and service industries and all the distribution and retail businesses.

The early years of a business appear to be crucial for its chance of survival. Indeed, and as shown by Appendix IX, 55% of the bankrupt firms in 1980 had been in business for less than five (5) years and over 80% for less than ten (10) years. This is most revealing both of the ease of setting up a business and of the element of risk involved. Certain articles in specialized publications even show that, "out of twenty (20) small and medium size newly launched businesses, nineteen (19) will close down in the first ten (10) years of their existence".⁽¹⁾ They will not all close for reasons of insolvency or bankruptcy; yet these figures illustrate the small number of businesses that will survive the various fluctuations of Canadian economic life. What is more, this statement, by reinforcing the interpretation of statistics on the age of bankruptcies in Canada, leads us to inquire into the causes of business insolvency. The normal risk involved in launching a business does not in itself explain the high incidence of bankruptcy in Canada. Dun & Bradstreet attribute 90% of these failures to poor management. We will have an opportunity of analyzing the reasons for business insolvency in depth while examining the underlying concepts.

Statistics on bankruptcy of small and medium-sized businesses in Canada often raise the following question: is this type of business more likely to go bankrupt than other businesses? According to a study about to be published by a professor of the Ecole des Hautes Etudes Commerciales de Montréal, whom we met in the course of the study, there are, in proportion, as many bankruptcies among big businesses as among the small and medium ones. This study shows clearly that small and medium-sized businesses and bankruptcy are not synonymous and that this type of business is as well managed as the big ones. Moreover, we do not find the lay-offs and the partial closures of international firms in the statistics. In actual fact when Pratt & Whitney closes one of its plants and dismisses 1,000 employees this is equivalent to the bankruptcy of 100 small and medium-sized businesses with an average employment of 10. However, this is not shown in any statistics on bankruptcy. Bearing in mind these added factors it would be easy to prove that small and medium-sized businesses are as efficient as the big businesses.

(1) Source: Dell 'Aniello, Paul et Perreault, Yvon G. La PME au Quebec, "Commerce, Le Point, 1982.

2.2.2 Sequestration

There is no statistical data, that would allow an evaluation of the number of sequestrations in Canada over a given period. The Office of the Superintendent of Bankruptcies asks insolvency agents to complete a form and forward a copy, but is not in a position to enforce the request. Unfortunately, few copies are completed, on the pretext that the process is too time consuming. Moreover, insolvency agents, since they have no legal protection when rendering an opinion in a sequestration case, often prefer not to answer certain questions which might entail legal action. In a number of cases it is also the secured creditors who object to the disclosure of information deemed private and confidential.

The various information sources which might allow us to compile the pertinent statistics, that is, insolvency offices and financial institutions, simply refuse to co-operate for different reasons. The two (2) parties in question consider the information as private and confidential. Furthermore, the firms of insolvency experts fear that such information would allow deduction of their approximate turnover and thus comparison between the volume of various firms, which, once again, is very private and confidential.

In the framework of the study we have undertaken an inquiry with members of the Quebec Insolvency Association in order to compile certain statistics on sequestrations in the Province of Quebec. In spite of the confidentiality guaranteed to respondents and the support of the Quebec Insolvency Association's board of directors, only an 18% response was obtained, i.e. 15 replies out of 83 questionnaires distributed! This sample is, of course, not significant. It covers only 484 cases of the 3,306 bankruptcies in the Province of Quebec⁽¹⁾ (as shown in Appendix V) that is 14.6% of the total, and mentions only 117 sequestrations. In studying the replies received it seems evident that no reply was received from insolvency firms from the Montreal area, that work mainly on sequestration.

Bearing in mind the setback of the survey in the Province of Quebec, we have persuaded the Canadian Insolvency Association to carry out its own survey across Canada, using as an argument to ensure the cooperation of its members, the importance to the Federal Government of the study being carried out by the consulting firm of Raymond, Chabot, Martin, Paré & Cie. In order to maximize the response, the person in charge of the survey has held preliminary consultations with the members, has modified the

(1) Source: Office of the Superintendent of Bankruptcies, "Bulletin on Insolvency", Vol. 2 (1982).

questionnaire at their suggestion and has ensured the participation of the most important offices. The questionnaire will be accompanied by an explanatory letter, recommendations from the president of the Canadian Insolvency Association and a return sheet allowing the participation of all members to be checked, while respecting the confidential nature of their response. Unfortunately, to ensure the success of this measure, a number of delays had to be suffered. Wishing to avoid a repetition of last year's setback with a similar inquiry, the president will authorize circulation of the questionnaire only when a satisfactory participation rate of the members is ensured.

We are at this time uncertain about the survey and about its results, but are maintaining contact with the person responsible. A copy of the questionnaire's findings and interpretation will reach us as soon as possible if the survey is held as expected.

In the absence of statistics, we have asked persons interviewed to assess the relative extent of sequestration and bankruptcy. Generally speaking, the bankers and the insolvency agents of the Montreal area believe that:

- There are more bankruptcies than sequestrations.
- The total of liabilities of sequestration is much greater than that of bankruptcies.

However, the bankers and insolvency agents in the Toronto area believe that:

- The number and the total of liabilities of sequestration exceed those of bankruptcies.

Moreover, The Canadian Creditors Association for the Revision of Rights and Legislations estimates that:

- The number and the total of liabilities of sequestration equals 70% of those of bankruptcies.

As we can see, views are widely divergent and often even contradictory. Unfortunately, no one is in a position to validate or invalidate these views. On the other hand, we can determine the extent of sequestrations. Their impact on the Canadian economy is far from negligible and deserves attention.

2.2.3 Insolvent Businesses

As shown in Appendix X, the insolvency rate of Canadian businesses has increased from 82/10,000 businesses in 1976 to 131/10,000 in

1980.(1) As shown in Appendix XIII, the insolvency rate per 10,000 businesses in the U.S. has remained between 24 and 42/10,000 in the same period.(2) The insolvency rate in Canada is therefore 3 to 4 times higher than in the U.S. This can be explained by several factors. To begin with the Canadian economy is much more open to competition from foreign imports than is that of the United States. Moreover, the general business environment and particularly all the regulations applied to business by the various levels of government, impose higher overheads on the small and medium-sized Canadian businesses than in the U.S. Lastly, our southern neighbour's decentralized banking system makes individual banks more conscious of and responsive to their role in the community, and this favours the small and medium-sized businesses in financial difficulty.

The number of businesses in Canada is estimated at about one million.(3) Applying the insolvency rate of 131/10,000 in 1980, the number of insolvent businesses in the same year is shown as 13,100. By subtracting from 13,100 the number of bankruptcies in 1980, i.e. 6,595 (4), about 6,505 businesses are found to have closed down in 1980 for other reasons of insolvency. How many of the 6,505 other businesses have been subject to sequestration? No one knows and opinions on the subject cover a wide range, as already shown. This rough calculation does not allow a reliable evaluation of the number of sequestrations, but does allow an appreciation of their order of magnitude and their extent in relation to the number of bankruptcies.

2.2.4 Conclusion

The economic and social importance of small and medium-sized business no longer needs to be shown. We believe that it is important for government authorities to take decisions affecting the Canadian economy on the basis of data which is as complete and accurate as possible. Data available on business failures is incomplete since it covers only bankruptcies, i.e. about 50% of the total number of insolvent businesses.

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- (1) Source: Dun & Bradstreet, "Study of Commercial Bankruptcies in Canada", Toronto, 1980.
 - (2) Source: Dun & Bradstreet, "Business Failure Record", New York, 1980.
 - (3) Source: Department of Industry, Trade and Commerce, "New Statistics on Small Canadian Business", 1979.
 - (4) Source: Office of the Superintendent of Bankruptcies, "Insolvency Bulletin", Vol. 1, No. 1 (1981).

The various sources of information on sequestration having refused to cooperate, we believe that government intervention would make the missing statistics available.

2.3 Qualitative Assessment of the Present Situation

2.3.1 Brief Summary of Canadian Economic Life in the Last Five Years.

Canada has experienced economic recession in the past few years. For a proper understanding of the impact of recession on small businesses, it is necessary to bear in mind the character of the preceding economic expansion. Therefore, in order to summarize recent Canadian economic life, we shall divide it into two (2) periods, the period of expansion and the period of recession. For each of these periods we shall look into government, banking, consumer and business behavior and their effect on small and medium-sized business.

a) Period of Economic Expansion

In the early seventies Canada experienced economic expansion, tied very closely to that of the American economy. The sectors most favourably affected by industrial growth comprised the construction, automobile, agriculture, forestry, furniture and service industries and all commercial distribution and retail sales.

- Governments:

This period was characterized by a rapid increase in government spending, a high but relatively stable rate of inflation, relatively even interest and dollar exchange rates and a low unemployment rate. A number of financial aid programmes to business were set up. "Over 400 government aid programmes exist at the federal and provincial levels, and are available to Quebec small and medium-sized businesses."⁽¹⁾ We shall evaluate the impact of all these programmes on small and medium-sized business in greater detail in Chapter 3 of this report.

- Banks:

Banks also experienced a period of very rapid expansion. Credit was readily available, and all the more so as this was necessary for bank expansion. In this very competitive environment, banks engaged in a fierce contest to gain as large a share of the market as possible.

(1) Source: Dell 'Aniello, Paul et Perreault, Yvon G., "La PME au Quebec", Commerce, Le Point, 1982.

- The Consumer:

The period of expansion was also characterized by a very rapid rise in salaries and social benefits. The outlook for the future was rosy and savings were at their lowest, in contrast to spending.

- Business:

The economic environment was very favourable for launching a business. Credit was readily available, required capital outlay was very low, consumption was at its highest. Financial aid programmes, moreover, were available to complement financing by private institutions. Business experienced very rapid growth and a corresponding rise in fixed assets and overhead.

b) Period of Recession

It appears that recession in Canada set in in 1976. It was also in 1976 that an annually increasing number of sequestrations became evident. The sectors most affected by recession were, generally speaking, the same that were favoured by the preceding industrial expansion.

- Governments:

The late seventies were characterized by rising interest rates, decrease in the value of the Canadian dollar and increase in the inflation and unemployment rate, in fact, the bank lending rate changed from 6.75% in January 1976 to 21.50% in December 1980 and decreased to 15.75% in December 1981. ⁽¹⁾ Similarly, the Canadian dollar dropped from \$1.00 in January 1976 to \$0.81 in July 1981 to rise subsequently to \$0.84 in December 1981. ⁽¹⁾ The restrictive monetary policy was not backed by a decrease in government spending. The increased budget deficit had to be covered, in part, by successive tax increases and by the elimination of certain tax shelters.

- Banks:

Banks now have a much more restrictive lending policy and follow up loans very closely. Reference is even sometimes made to a "cleaning up" period for bank files. Banks call their loans to small businesses in trouble much sooner than formerly and resort to sequestration when they judge it to be expedient.

(1) Source: Bank of Canada, "Bank of Canada Review", January 1978 to February 1982.

- The Consumer:

The higher interest rates, unemployment and the number of bankruptcies have caused the consumer to be much more cautious and even timid. Savings have increased in the last five (5) years and have reached a peak in 1981. Concurrently, consumption has decreased, people are more selective in their purchases and seek the best value for their money.

- Business:

The majority of Canadian businesses have experienced a decrease in sales in the past five years, and especially in 1980 and 1981. Those businesses that have been unable to adapt rapidly to a changing climate have also suffered inventory increases, increases in receivables and financial costs and a rise in an already excessive overhead.

2.3.2 1982 Forecast

"The nineteen eighties are characterized by zero economic growth, uncontrolled fluctuations of interest rates, chronic unemployment, increased international competition, a strong recession and constant inflation", wrote a UQAM professor in the March 1982 issue of the magazine 'Commerce'⁽¹⁾. According to the general opinion of bankers and insolvency agents, interviewed in the course of our interview programme, 1982 will be as difficult if not more so than 1981 for small and medium-sized business if interest rates remain high or continue to increase. Businesses who just got by in 1980 and 1981 may well fold in 1982. Bankruptcies and sequestrations for this year are expected to be as high as in '81. Business recovery is expected only towards the end of 1983.

2.3.3 Conclusion

Whereas at the time of economic expansion, the great majority of the managers of small and medium-sized businesses were successful, only 'geniuses' can make ends meet in times of depression. The 'geniuses' are the managers who, if they do not possess the ability to foresee environmental changes, then at least have the capacity to adapt very quickly. The least delay in reacting to change can be fatal to the business. Unfortunately small and medium-sized businesses are, in general, very slow in adapting to change and are thus very vulnerable to changes in the business climate. We are now paying the fair price of easy access to

(1) Source: Dell 'Aniello, Paul et Perreault, Yvon G., "How can Small and Medium-Sized Business Survive the Eighties", Commerce, March 1982.

business in the seventies. Failing government aid to small businesses now in trouble - either devoid of the capital structure needed for efficient operations, or lacking the quality of management required to survive the crisis, - an increase in bankruptcies and sequestrations must be expected in 1982.

Chapter 3

3. Analysis of Government Policies

Our study of the climate in which business operates would be incomplete without an analysis of government policies. These policies have a very considerable influence on the life of small business. The high interest rate policy is continually cited as the chief reason for bankruptcies in Canada; the last federal budget is often criticised by the small businessmen; and the Bill on bankruptcy and insolvency is the subject of numerous comments by ordinary creditors and small and medium-sized business. Moreover, contradictory as it may seem, certain government incentives have been the indirect cause of a number of bankruptcies. The body of government policies is therefore an integral part of the environment to which small business must constantly adapt. It seems to us important to sum up these policies before embarking on the causes of bankruptcy and sequestration.

The bulk of Canadian government policies could be subdivided in a thousand and one ways. In this socio-political study we shall use three (3) main subdivisions: macro-economic, micro-economic and legal policies for purposes of general evaluation. We shall consider their relation to national objectives concerning the Canadian economy and shall then study their impact on small business.

3.1 National Objectives of Canadian Economic Policy

National objectives which concern the Canadian economy as a whole are implicit in the objectives of every government policy. To our knowledge, they are not stated in any document. Nevertheless, the principal objectives can be deduced as follows:

- The present government, by means of its monetary policy, has repeatedly made clear that its long term objective is to control inflation. The maintenance of the Canadian dollar is needed for the achievement of this objective and justifies in full this policy of restriction.
- Reduction of unemployment is an objective, which, at first sight, may seem contradictory to the above. It is hoped, in the more or less short term, that the undesirable effects of a restrictive monetary policy will be attenuated by various schemes of job creation, regional development and various grants to firms.
- Several of the policies which support the export of Canadian goods and services are aimed at an improved balance of payments.
- A decrease, in the long term, of the Canadian government's budget deficit is at the root of restrictive budgetary policies.

The list of national objectives could be extended further, but the above will suffice for a very general analysis of government policies as they affect small business.

3.2 Macro-economic Policies

Macro-economic policies are those which have an impact on the Canadian economy as a whole. We have selected, for the purpose of this study, the two (2) most important policies, the monetary and the fiscal policy, because of their impact on small business.

3.2.1 Monetary Policy

Whether there is agreement or not on the soundness of the restrictive monetary policy which the present Federal Government follows, its negative effects on the Canadian economy as a whole cannot be ignored. Small businesses are hurt most by the high interest rates, and the government knows this. For this reason it has set up various programmes of financial aid to businesses, such as Small Business Development Bonds (SBDB). Moreover, the Federal Business Development Bank continues to lend to businesses who have financing problems on the private money market, and sometimes invests by providing equity in order to offset the shortage of available risk capital.

A great majority of the individuals interviewed for this study have very clearly stated their interest in this type of government intervention. The fact that businesses unable to satisfy their financial needs on the private money market, because of the high risk of their business, can have recourse to alternate financing through government agencies is now recognized as a necessity. Furthermore, the government is thought to fit very well into this role. The wish is even expressed that the government extend this type of programme and make it better known by means of aggressive publicity. The only misgivings expressed on the subject of these programmes seems to us to be quite valid. If the government agencies in question fail to act in a very selective manner, they will encroach on private money markets and overstep their mandate.

3.2.2 Fiscal Policy

In the opinion of several persons interviewed, the fiscal policy of the Canadian government would not favour small and medium-sized business as much as it would seem at first glance. It is true that the base taxation rate for small and medium-sized business is less than for big business by as much as 25%. On the other hand large businesses can take advantage of numerous tax shelters of limited use to the small business. In fact, large businesses, with their lower debt-equity ratio and lesser risk of doing business, can pay dividends on common stock much lower than those paid to the owners of small and medium-sized businesses and thus reinvest a much

higher proportion of the profits in the firm. Such reinvestment, as practiced by large business concerns, creates various tax shelters by allocation of capital costs which can be as high as 50% of the fabricating cost, by a tax investment credit on these same assets, or by research and development expenditures deductible at 150% of the sums invested.

Inversely, small business just pay its shareholders a high dividend in recognition of business risks. The retained profits can be reinvested in two (2) ways, either by purchase of fixed assets or by partial repayment of bank loans. Because of their inherent capital structure, it is often necessary for such companies to reinvest their profits by partial repayment of bank loans, which does not provide any tax shelters. Only a small part of the businesses who reinvest their profits by purchase of fixed assets are in the manufacturing sector. For these firms, the purchase of equipment provides a tax investment credit and a capital cost allowance equal to 50% of the investment. Other businesses, and chiefly wholesalers, retailers and service industries, tend to invest in movables or inventory, which generates very little capital cost allowance to serve as tax shelter. Moreover, the few small and medium-sized businesses that invest in research and development are unaware of the fact that they can deduct up to 150% of the invested funds, or else do not have a sufficiently sophisticated information system to establish the sums eligible for deduction. The additional cost involved in a suitable information system would be considered too high in relation to the gains to be obtained. It is for these reasons that we believe that the real tax rate is not significantly lower for small and medium-sized business than it is for large enterprises.

Prior to the Canadian Government's last budget, fiscal policy granted several advantages to small investors to compensate for the above disadvantages to small investors to compensate for the above disadvantages to small and medium-sized business. However, in November 1981, the Minister of Finance, in his new budget, abolished most of the tax shelters enjoyed by investors in small and medium-sized business. According to the Canadian Federation of Independent Business: "by cutting the deduction for depreciation by half, by limiting interest deductions on loans to small businesses and on the sale of fixed assets, and by eliminating the advantages of the Small Business Development bond programme...the small investors were dealt a blow rather than receive a helping hand..."

3.3 Micro-Economic Policies

Micro-economic policies are those which apply directly to individual businesses. Here we refer to the incentive policies. There exist over four hundred (400) programmes of financial aid

to business, some better known and more widespread than others. These include the Department of Regional Economic Expansion (D.R.E.E.), the Industrial Research Assistance Programme (I.R.A.P.), the Enterprise Development Programme (E.D.P.), the Programme for Export Market Development (P.E.M.D.), the Export Development Corporation (E.D.C.), the Canadian International Development Agency (C.I.D.A.), and the Regional Development Incentives Programme (R.D.I.P.). All these programmes aim to provide financial assistance in widely different forms to those businesses that are eligible and have requested aid. Whatever the programmes, they have a certain impact on small business and they all share the same problems of administration.

3.3.1 Impact of the Incentives Programmes

When started, all incentive programmes showed the Federal Government's excellent intentions. They allowed the creation of many new jobs, the development of new industrial sectors or even the economic development of regions more or less distant from the big centers. However, in the application of the various financial aid programmes, the special and specific aims of each incentive programme, rather than the overall goals of the Canadian economy, are often perceived as the ultimate objective. In the course of our interviews, several instances were mentioned where the meeting of a programme's very specific objective, sooner or later, ran counter to the national goals of the Canadian economy.

Take the example of a new business which has just obtained a grant-in-aid through a regional development programme. The new business steps into a market which is currently served by five (5) other businesses and is already saturated. The five (5) businesses which share the market have worked in this area for the past five (5) to ten (10) years and have an average labour force of one hundred (100) employees each. Their equipment is not up to date, but they cannot afford more modern equipment. The new business on the other hand, because of the grant-in-aid, is equipped with the latest equipment which allows for production equal to that of its five (5) competitors at lower production cost, since it employs a labour force of only one hundred and fifty (150). Sooner or later the other five (5) established businesses will have to close down, being unable to compete. In this particular case the programme's objective, i.e. regional development, is attained. A new business is brought into being and is established in a region to be developed. But the loss of three hundred and fifty (350) jobs, is counter-productive with regard to the national objective of reducing unemployment.

We can also cite the example of sectorial development. An industrial sector is in the process of expansion. Subsidies are granted to the majority, if not all, of the businesses which would like to operate in this sector. Several years later more than half

have to go out of business, because the market is not large enough for all the competing businesses and neither credit nor incentives are available. Once again the objective of the programme is reached, but to the detriment of the national objectives.

One final example concerns the cutbacks in government incentives or subsidies without advance notice to the businesses concerned. The purchase of a product is subsidized and demand rises as the result of this artificial price reduction. Businesses plan their production and their fixed assets on the basis of the suddenly increased demand; then, overnight, the subsidy is gone. The businesses bind themselves with excess capacity and with far too high an inventory. Few will survive this unexpected development.

These three (3) situations have been described in the course of interviews and seem to be common in Quebec and Ontario. Particular mention was made of sectors badly affected in the past few years, namely prefabricated homes, pig farms, manufacturers of agricultural equipment, snowmobiles, trailers and camper-trailers, and wineries.

To avoid recurrence of such situations, and before incentives are granted, it would be essential to study their effect, not only on the business in question, but also on the whole market the business is to serve and on the companies already active in the sector.

3.3.2 Administrative Problems of the Incentives Programmes

The increasing number of financial aid programmes to business gives rise to numerous problems of administration. The profusion of incentives programmes confuses the typical small businessman. The programmes are not always adapted to the clients and the small businessman finds it difficult to find his way through the labyrinth of programmes. Most of the publicity for these programmes reaches management professionals only, being circulated mainly by means of specialized journals.

In one way or another, all the persons interviewed commented on how slowly decisions were taken in the framework of the programmes. To a new business, a waiting period of several months represents a high cost, both to the investors and the public, yet this might be the fair price to pay for the existence of the incentives programmes. Nonetheless, the closure of a business because of its inability to survive the few months needed for a favourable decision is a very high price to pay. This situation occurs very frequently when a trustee or an insolvency agent attempts to sell or to save a firm which is still in operation. Trustees or insolvency agents can seldom afford to wait more than one (1) or two (2) weeks for a reply to a request for a subsidy, or for approval of the purchase of a firm by foreign investors. Since these instances are not treated by the government agencies as

priorities, replies are almost invariably received several months after the liquidation of the firm by the trustee or insolvency agent. It would perhaps be of advantage to all, given the objectives of the Canadian economy, if priority and prompt attention were given to requests submitted by trustees or insolvency agents who wish to prevent the liquidation of operating companies.

Lastly, some bankers have drawn to our attention the number of documents required to obtain government aid. It is quite justifiable that a number of conditions be met before obtaining subsidies. On the other hand, what happens when the subsidy is granted and spent? In most instances the case is not followed up and the business is free of all promises and obligations. A regular follow-up by experienced managers would help many a business in difficult straits, and, in some cases, prevent bankruptcy. Moreover, the taxpayer would at the same time receive assurance that the subsidies are granted for a useful purpose.

3.4 Legal Policies

In the course of our interview programme, we have discussed the proposed legislation on bankruptcy and insolvency. In general, the trustees in the Montreal area are happy with the proposed legislation and would like to see it adopted as soon as possible. The trustees in the Toronto area, for their part, are satisfied with the changes proposed, but would rather see the present law amended than a new one enacted. This would prevent cancellation of jurisprudence formulated over the years.

On the whole, the trustees have mentioned the relevance of the following changes:

- The elimination of former priority treatment of government debts.
- The uniformity across Canada of treatment of debt in cases of bankruptcy and of sequestration.
- The need to protect wages and other monies due to the employees.
- The advance notice in composition proceedings.
- The trustees' rights on leases and leasehold improvements.
- The authority vested in courts with respect to sequestration.
- The need for statistics on business insolvency and especially on sequestration.

On the other hand, the Canadian Federation of Independent Business is far from satisfied with the proposed legislation: "here are some of the problems ignored by Bill C-12: the obvious possibility of conflict of interest between the management consulting and the sequester, bankruptcy or receivership departments of a chartered accounting firm; the failure to give advance notice of sequestration of a business to the nonsecured creditors; the cost of sequestration; the lack of control over sequestered accounts in the framework of the liquidation of assets."⁽¹⁾

In this memorandum, submitted to the Minister of Consumer and Corporate Affairs on December 10, 1980, the Federation makes the following five (5) recommendations:

- "To remove all possible conflict of interest, there should be an arms-length requirement in Bill C-12 separating to-management consulting a receivership/trusteeship functions.
- Section 355 of Bill C-12 be amended to include notifying unsecured creditors of the firm in receivership as a duty of receivers.
- There should be closer scrutiny of the fees charged by the receivers.
- Section 359 of Bill C-12 should be changed to require disposal of assets by public auction, or prior approval by the majority of creditors of a private sale.
- Employees' wages should have priority over unsecured creditors."⁽²⁾

Lastly, the Canadian Creditors Association for the Revision of Rights and Legislations also voices its dissatisfaction with respect to the proposed law: "The C.C.A.R.R.L. wants fair consideration for the supplier of sales and services for transactions occurring within ninety (90) days prior to sequestration. It wants adequate legislation and regulation by law of the activities of the agent-receiver who is the trustee of the secured creditor. It wants to increase the role of the Superintendent of Bankruptcies in matters of control, to allow the

(1) Source: Canadian Federation of Independent Business, "Memorandum on Bankruptcy law with Regard to Bill C-12", December 10, 1980.

(2) Source: Canadian Federation of Independent Business, "Memorandum on the Bankruptcy Law with Regard to Bill C-12", December 10, 1980.

compilation of national statistics and to prevent premature, exploitive actions detrimental to the interests of the other creditors." (1)

The following legislation is requested:

- a) The agent-receiver authorized to proceed with sequestration must:
 - Advise all the creditors within three (3) days of being appointed and inform the Superintendent of Bankruptcies.
 - Within fifteen (15) days of termination of his mandate render an account of his performance to the creditors and to the Superintendent of Bankruptcies.
- b) The unsecured creditor whose business has been transacted within sixty (60) days of sequestration can, after having duly proved his claim:
 - Repossess the goods sold, provided these goods are still in the same condition and in the possession of the sequestered debtor.
 - Or, if this is not possible, with the agreement of the other secured creditors, share the prorated gains of liquidation with the creditor who initiated the sequestration." (2)

Opinions vary according to the groups concerned. The insolvency agents, trustees and secured creditors are satisfied with the bill of which they are the principal beneficiaries. Small and medium-sized business representatives and non-secured creditors still call for regulation of sequestration of which they are the main victims. The solution to this conflict rests perhaps in the national objectives of the Canadian economy. Would not improved rights for unsecured creditors in cases of sequestration be a suitable device, by avoiding unnecessary losses, to slow down the chain reaction of bankruptcy on other small and medium-sized businesses and the ensuing lay-offs, and thus lead to a reduction of unemployment in Canada?

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- (1) Source: The Canadian Creditors Association for the Revision of Rights and Legislation, Memorandum, March 26, 1982.
 - (2) Source: The Canadian Creditors Association for the Revision of Rights and Legislations, Memorandum, March 26, 1982.

One last point also deserves mention. The Canadian Insolvency Association, an organization which comprises the majority of those who work as official receivers and trustees, has included, in order to eliminate possible conflicts of interest, the following articles in its professional code of ethics:

"4. A member shall with respect to any professional engagement hold himself free of any influence, interest or relationship which impairs his professional judgement or objectivity or which, in the view of a reasonable and informed observer, has that effect.

17. A member shall not permit himself to be placed or remain in a position where a conflict of interest may exist, or may appear to exist, without making full disclosure to, and obtaining the written consent of, all interested parties."⁽¹⁾

3.5. Conclusion

The sum total of government policies on aid to business certainly has a positive impact on the Canadian economy. However, as mentioned by a professor of the Ecole des Hautes Etudes Commerciales in the journal "Gestion" of February 1981: "little sign can be found of any significant concern as to the overall impact of all aid programmes offered to business."⁽²⁾

The lack of co-ordination of all the programmes weakens the results obtained. The ultimate objective of the majority of programmes, in concert with national objectives, is to create employment. Unfortunately, this objective is sometimes abandoned for another more immediate aim. Apart from lack of co-ordination, there is also an apparent lack of continuity in the various programmes, a lack of publicity directed at selected groups and a lack of follow-up of the businesses selected for aid.

(1) Source: Canadian Insolvency Association, Code of Professional Ethics.

(2) Source: LeGoff, Jean-Pierre, "Government Financial Aid Programmes to Business: Some Reflections," Gestion, February, 1981. Translated from original by Raymond, Chabot, Martin, Paré & Associés

Chapter 4

4. Determination of Reasons for Business Insolvency

4.1 Comparison of Bankruptcy and Sequestration

Bankruptcy and sequestration are the two (2) most frequent means used by creditors to recover their loans made to businesses which have run into trouble. They differ both in form and in the effect they have on the business and on the creditors. We will compare the decision criteria which devolve from bankruptcy and sequestration, their process of implementation and their advantages and disadvantages to the various parties involved.

4.1.1 Decision Criteria

a) Bankruptcy:

The decision criteria which lead to bankruptcy are:

- The loss of hope, by the directors of the company or by one or more creditors, of possible improvement in the firm's financial position.
- Deterioration of the firm's financial position.
- Failure to meet payments overdue.
- Conflict between one or more creditors and the managers of the firm.
- Rejected composition proceedings.
- Fraud by the firm's managers.

b) Sequestration:

The decision criteria leading to sequestration are:

- Secured creditor's loss of confidence in the directors of the firm.
- Deterioration of the firm's financial position.
- Inability to meet payments overdue to the secured creditors.
- Delay in providing financial reports to secured creditors.
- Conflicts between one or more secured creditors and the managers of the firm.

4.1.2 The Process

a) Bankruptcy:

The decision criteria which lead to bankruptcy are:

Bankruptcy can be voluntary, (i.e. requested by the owners of the business). It can also follow a petition, as stipulated by the Bankruptcy Act, duly signed by one of the creditors, or by the rejection of a composition proceeding. An assignment of assets in favor of the creditors must then be filed with the official receiver. A trustee is then appointed by the court and acts on behalf of all the creditors, maximizes the gains from liquidation of the assets of the business and distributes fairly the monies received according to the priorities established by federal law.

b) Sequestration:

The secured creditor selects an insolvency agent and requests the seizure of business assets held as security against loans made by the lending institution. The agent evaluates the financial position of the business and recommends a course of action to maximize the value of the liquidated assets and the reimbursement of the loan to the secured creditor. If on the other hand the secured creditor judges that it is to his advantage to continue operation of the firm, then the insolvency agent, acting as the firm's director on an interim basis and assisted by the owner and the managers, will attempt to put the firm back on its feet.

4.1.3 The Advantages

a) Bankruptcy

Bankruptcy has a theoretical advantage for ordinary creditors. The trustee is in fact appointed to represent all the creditors, be they secured, preferential or ordinary. The ordinary creditor can therefore follow the proceedings closely and thus protect himself against possible exploitation by the secured creditors or fraud committed by the managers. The trustee is held responsible for the examination of the validity of all so-called secured debts and for advising all creditors of the progress of proceedings. All the trustee's important decisions must be approved by the inspectors appointed by the creditors' general meeting.

Bankruptcy has also some advantages for the secured creditors. Governed by provincial laws, sequestration proceedings offer precedence to monies due to the lessor and to certain government claims over secured debts. Under the federal bankruptcy laws, such creditors are relegated to the category of preferential debt (i.e. with priority immediately after that of all secured debts). It happens frequently that secured creditors prefer to file for a

firm's bankruptcy in order to avoid payment of the lessor's and the government's claims. The only other cases where the secured creditors prefer to file for a firm's bankruptcy are cases of fraud and cases of conflict between several secured creditors.

For the business in trouble, bankruptcy presents no advantage other than to free it from a position of insolvency.

b) Sequestration

For secured creditors there are many advantages inherent in sequestration. First, the cost is considerably less in terms of time lost and of debts recovered. Moreover, the insolvency agent working on behalf of the lending institution is not held to examine the validity of the claims. It has happened that secured creditors, with somewhat doubtful claims, have taken possession of a firm's assets and quickly sold them, to the disadvantage of the ordinary creditors. Finally, sequestration allows secured creditors to act promptly when they feel that their security is in danger, as, for example, in the case of a supplier who attempts to seize a business inventory.

Sequestration presents no advantage to the ordinary creditor because it excludes him. Bankruptcy is his sole recourse.

Nevertheless, sequestration has one advantage for the business. Its chances of survival are greater, being almost nil in bankruptcy. As a matter of fact, should the insolvency agent recommend the continuation of operations and succeed in rectifying the firm's financial situation, survival is possible. This happens fairly frequently, but statistics unfortunately are unavailable and it would be impossible even to determine an order of magnitude of the number of such happy occurrences.

4.1.4 The Disadvantages

a) Bankruptcy:

Bankruptcy is a very costly procedure and is considered as terminal for a business, which is in most cases liquidated in the process.

b) Sequestration:

The only disadvantage of sequestration for secured creditors is the priority given to lessors' and to government claims. This often leads the secured creditors to avoid this obstacle by filing for bankruptcy. As for ordinary creditors, sequestration presents all the disadvantages of their being excluded. They have no control whatsoever over the insolvency agents and are therefore very vulnerable vis à vis secured creditors. In any case, when sequestration takes place there seldom exists sufficient funds to

justify the cost to an ordinary creditor of forcing the firm into bankruptcy. As for the business itself, its only danger is of suffering from a bad decision by the secured creditors, against whom it has no recourse.

4.1.5 Conclusion

The decision between bankruptcy and sequestration of a business rests in the hands of creditors. The secured creditors can choose between the two processes, but the ordinary creditors must choose bankruptcy. Even though reports show that 90% of bankruptcies are voluntary, they nevertheless stem from action consciously taken by the creditors, be it freezing of bank accounts, return of checks, recall of loans, refusal to supply the business, threat to file for bankruptcy and many others. The decision remains a business decision taken, suggested or forced by the creditors.

The underlying causes of business insolvency are the same for both bankruptcy and sequestration. Only the circumstances and the chances of survival are different.

4.2 Immediate Reasons for Business Insolvency

Among the reasons for business failure most often mentioned, there are those which are beyond management's control. We have subdivided the reasons for failure into three (3) categories: economic, financial and structural reasons.

4.2.1 Economic Reasons

The general economic climate certainly has an impact on small Canadian businesses. Market competition sometimes precludes product price increases in line with increased costs. Indeed, it is better for the business to sell at a loss than to bear the financial cost of too high an inventory. Decreased activity in certain sectors of the economy is currently being cited as the cause of difficulties, and the sectors most often mentioned are construction, the automotive sector and agriculture.

High interest rates are mentioned unanimously as the main reason for business insolvency. They have a dual impact on business. First, they result in greatly increased financial costs. Second, they affect consumption indirectly causing reduced sales, increased inventories, increased borrowing from banks and again, an increase in financial costs. Thus, business is hit twice by high interest rates.

Lastly, certain government interventions, with barely adequate planning and still less co-ordination create a very unstable environment and an uncertain and harmful climate for the investor and the manager. To mention only a few such interventions, there

are incentives to new businesses which aim at penetration of saturated markets; unexpected cutbacks of incentives or expenditures; budgets which at one stroke eliminate almost all the tax shelters used by small business owners.

4.2.2 Financial Reasons

Small business undercapitalization is the reason most often mentioned after high interest rates. In a capitalist economy, free enterprise is defended by all and access to it is made as easy as possible. Thus, a very large number of firms were launched with minimal capital outlay, sometimes as little as one dollar (\$1.00), the balance being financed by the banks. Moreover, risk capital sources in Canada, and particularly in Quebec, are little known, limited and very conservative. Several of these undercapitalized businesses have therefore contributed to the increased number of bankruptcies in the past five (5) years.

The period of economic expansion which we have experienced has opened wide the doors to credit. The capital outlay being minimal, there were ideal opportunities for making life-long dreams come true and launching into business. Banks agreed to finance businesses, but required unduly high security. Business was thus trapped and was at the mercy of the banks who had taken everything as security. It was no longer possible for businesses to benefit from additional financing, except from stock floatations, which was far from easy. Thus began, a few years later, sequestrations initiated by secured creditors. The number of the sequestrations and bankruptcies is the fair price to be paid by the public for a free and easily accessible market.

4.2.3. Structural Reasons

Going into business inevitably involves risk and it is therefore quite normal to experience a certain rate of failure. These can have any number of causes, as, for example, the normal shrinking of a market after some years of existence, serious conflicts arising between the associates of a business, or a faulty evaluation of risk during the formation or expansion of a business. The future is unknown and some unforeseeable major events are often the cause, structural in nature, of a business failure.

4.2.4 Conclusions

All Canadian businesses face the same economic, financial and structural constraints. Some, nevertheless, survive. There exist, therefore, other and more deep-rooted reasons which explain business insolvency. While it would be interesting to make a comparative study of profitable and unprofitable firms, this would exceed the scope of this study.

4.3 Underlying Reasons for Business Insolvency

The underlying reasons for business insolvency are generally those which are subject to control by the management of the business. On the basis of twenty-two (22) firms which we have studied, we have constructed two typical models of the small Canadian businessman's behavior, and this will help us to deduce the main underlying reasons for business insolvency; the reasons of an administrative nature.

4.3.1 Two Typical Cases of Entrepreneurial Behaviour of Canadian Small Businessmen

a) First Scenario:

The business is managed by the owner or by one of the shareholders, the others being silent minority partners. The manager of the business is either a good salesman or a good technician and knows very well his product (or service) which, on the whole, is of good quality. The business is financed entirely by a bank, except for a minimal capital outlay by the shareholders. The bank has taken maximum security in exchange (i.e. the building, the site, the equipment, the inventory, the receivables, a floating bank charge and the personal belongings of the owners and sometimes even of their wives).

For a few years, usually 4 to 6, the firm does very good business. The owner takes advantage of this to recoup his investment by means of salary, dividends and expenses paid by the firm. He does not think it necessary to establish a reserve fund. Indeed, overhead rises rapidly. The firm provides an automobile for the owner and credit cards for the most important employees. The firm might even acquire a small computer. As sales forecasts for the years to come are most favourable, the decision is taken to expand operations. The expansion is wholly financed by the bank. Moreover, at this stage, the owner is not at all interested in association with other investors or managers and thus in sharing his empire.

Now come the difficult years. Interest rates climb, sales drop, inventories and receivables rise, the margin of bank credit is exceeded. The business has been too slow in adapting to the changes of the environment. The impression was that the difficult times would not last long, but they seem to persist. The business, having no financial reserves, is in urgent need of additional funds. The bank obviously refuses, having already loaned all the funds it intended to loan. There is no way of negotiating with other banks or lending institutions, since the first bank already holds all the assets of the firm as security. As for private investors, they are no longer interested in investing risk capital, given the financial position of the firm. Suppliers, unpaid for several months and aware that in the event of bankruptcy or

sequestration they will receive nothing for the inventory supplied to the firm, prefer to stop supplies. Without supplies, the firm cannot continue operations. The bank takes possession of the firm.

b) Second Scenario:

The business is managed by its sole owner, who, as in the first scenario, is either a good salesman or a good technician and knows his product well. The business is financed by a more substantial, but still inadequate capital outlay and by a bank loan against the usual type of securities.

His main competitors are firms operating on a national scale. His market share is derived from the fact that his gross profit margin is 10% less than that of his competitors. There is no management information, control or cost price determination systems in the firm. Accounting is done by a more or less competent bookkeeper. It is not unusual to find in the course of a thorough study during bankruptcy or sequestration that such firms were the victims of theft or waste by their own employees.

All decisions are taken on the basis of information extraneous to the company. If the competitors sell for \$100 the owner will sell for \$90, knowing that the direct cost of his product is \$60. He then believes he has made a \$30 profit on every item sold. But he does not know what the indirect costs are. Possibly \$45/unit? In short, the business is less profitable than believed.

If, at times of economic expansion, competitors achieved a profit margin of 25 to 30%, the owner will be satisfied with a gross profit of 15 to 20% and an after-tax profit of 2 to 5%, sufficient for the survival of the business. But, at times of economic recession, when shrinking markets and increased competition force the firms operating on a national scale to reduce their gross profit to about 15 to 20%, this owner will have to be satisfied with a gross profit margin of 5 to 10%, which will be insufficient to cover his overhead. Before he even has time to realize that his business has been operating at a loss, the bank will sequester the business and bankruptcy will perhaps ensue.

4.3.2 Reasons of an Administrative Nature

The two (2) above scenarios are typical of the behavior of Canadian small businessmen. In fact, fourteen (14) of the twenty-two (22) businesses selected for our study can be placed in one of those two (2) scenarios. After discussion with a number of people, we even believe that they could be extrapolated to the totality of Canadian bankruptcies and sequestrations.

Insolvency of Canadian businesses is thus caused by a series of bad decisions which, even though bad, would not have had a significant impact in a stable or expanding economy, but were fatal at this time of recession. These bad decisions are, in major part, the result of lack of organization at the administrative level:

- To begin with, the managers do not have the necessary human resources available in the business itself to make the best decisions. One cannot expect the head of a business to excel in all areas. If the owner is a good production manager, he is not necessarily, by the same token, a good salesman or a good financial director.
- Furthermore, the managers do not always see the need or the usefulness of availing themselves of the human resources lacking. To hire an accountant, a lawyer or a director of marketing is, to them, an unnecessary expense. They believe they can do everything themselves and do it well.
- Managers are reluctant to discuss their business with resource persons available outside the firm. There are, on the market, consultants available to counsel small and medium-sized businesses at reasonable cost. As a general rule, bankers would be ready to advise their clients, provided the clients were prepared to discuss their problems openly and regularly. But the managers take the view that the less the banker knows, the better the firm will fare. The various government agencies could also be valuable sources of information and advice, but the managers are not sure to whom they should turn.
- Lastly, managers do not want to share their business with other investors or directors, or even to delegate responsibility to employees. The sole owner who worked three (3), five (5), or even ten (10) years to set his business up does not want to share the fruit of his labours. The arrival of one or several associates would, in his view, be a loss of independence, power and profit. Similarly, to delegate responsibilities to employees would be to risk destroying that which has taken so long to build up. He must therefore see to everything himself and be responsible for everything himself, and this can often lead to major difficulties. Lacking time, he gives priority to the things he judges important and neglects other often equally important aspects of management.

4.3.3 Other Reasons

Among other reasons tied more or less directly to the management of the business are those related to new businesses that start operations without having first made sure that there is a market for their product and without evaluating the size of the market which they want to penetrate. It is not unusual for a firm to

market a new product, with sales falling well below expectation. If the firm is seriously held up because of this inadequate knowledge of the market, and fails to reorganize in relation to its real share of the market, it might not survive a single year.

Absence of motivation of the owner or owners is also a reason for business insolvency. This is found especially among owners who are affluent enough even without the revenue which the business represents. After a very prosperous period, much time and effort is now needed to maintain the profitability of the business. The profit derived being insufficient to maintain motivation, they prefer to have the banks take possession of the business rather than to keep it going.

Lastly, we have been told, in the course of our interviews, and more especially in the Toronto area, that the number of cases of frauds is rapidly increasing. According to Dun & Bradstreet 0.4% of Canadian bankruptcies resulted from fraud.⁽¹⁾ These statistics do not, unfortunately, reflect reality. As a matter of fact, the majority of fraud cases are not reported by trustees for several reasons. First, intervention of the RCMP in the case occasions very considerable delays (a period of several years is mentioned) and much additional work without remuneration. Moreover, the persons committing fraud very seldom appear in court and, in rare cases where sentence is passed, penalties are purely nominal. Lastly, when a trustee suspects fraud in a bankruptcy case under review, he must prove it before he declares it. If funds are insufficient to justify extra time being spent on the case, as is common in 99% of cases, the trustee will simply overlook his suspicions. It is therefore very difficult to make an accurate evaluation of the actual incidence of fraud in Canadian bankruptcies.

4.3.4 Conclusion

The underlying causes of business insolvency are of an administrative nature. As a general rule, small business owners refuse to admit their lack of experience and of business expertise, as well as the usefulness and profitability of the potential contribution of resource persons outside the business. Furthermore, they reject all options of association with private investors which could improve the capital structure of the firm and reduce dependence on lending institutions. This type of behavior is the main reason for the majority of the management problems of small businesses in trouble. A study, at the inception of the business, of its capital structure and of its managerial behaviour would allow evaluation of its chances of survival. The two (2) typical scenarios illustrate the type of businessmen to be dealt with in trying to improve the prospects for small business, and the type of behavior that must be changed.

(1) Source: Dun & Bradstreet, A Study of Commercial Bankruptcies in Canada, Toronto, 1980.

APPENDICES

APPENDIX I

Methodology

1. Collection of documents from all the private and public organizations which might possess information applicable to this study.

See: Appendix II: List of all the organizations contacted.

Appendix III: Bibliography.

2. Collection of bankruptcy statistics:

a) From the office of the Superintendent of Bankruptcies:

See: Appendix IV: Annual statistics on bankruptcies in Canada.

Appendix V: Annual statistics on bankruptcies in Quebec.

Appendix VI: Annual statistics on bankruptcies in Ontario.

b) From Dun & Bradstreet:

- Canada

See: Appendix VII: Annual statistics on bankruptcies in Canada by industry.

Appendix VIII: Annual statistics on bankruptcies in Canada by Province.

Appendix IX: Bankruptcy by age of business in Canada in 1980.

Appendix X: Insolvency rate per 10,000 Canadian businesses.

- United States

See: Appendix XI: Annual statistics on bankruptcies in the U.S. by industry.

Appendix XII: Bankruptcy by age of business in the U.S. in 1980.

Appendix XIII: Insolvency rate per 10,000 U.S. businesses.

3. Collection of statistics on sequestrations from the Quebec Insolvency Association.

See: Appendix XIV: Questionnaire circulated to members of the Quebec Insolvency Association.

4. Selection of a sample of 25 small businesses.

a) Selection criteria:

- 15 businesses in the Montreal area and 10 in the Toronto area.
- 10 bankruptcies and 15 sequestrations.
- Businesses to be selected by different trustees' offices.
- The bankruptcies and sequestrations must have taken place in 1981.
- The businesses must have had a turnover of less than \$10 million with concentration on businesses with a turnover not exceeding \$2 million.
- The businesses must have no more than 250 employees, with concentration on businesses with no more than 100 employees.
- The businesses must be of different age.
- The businesses must operate in various industrial sectors.

b) The businesses selected:

- One of the trustees' offices in the Montreal region has refused to submit to us the three (3) cases in question within the required time-limit. Because of this, our sample will consist of 22 businesses rather than of 25, as previously intended.

See: Appendix XV: List of 22 selected businesses.

Appendix XVI: Profile of 22 selected businesses.

5. Interviewer's programme:

See: Appendix XVII: Interviewer's guide.

Appendix XVIII: List of persons interviewed.

APPENDIX II

List of all the organizations contacted.

1. Canadian Bankers Association
2. The Canadian Creditors Association for the Revision of Rights and Legislations
3. Federal Business Development Bank (Library)
4. Royal Bank (Library)
5. Canadian Insolvency Association
6. Quebec Insolvency Association
7. Dun & Bradstreet (Canada and the United States)
8. Ecole des Hautes Etudes Commerciales (Library)
9. Canadian Federation of Independent Business
10. Department of Industry, Trade and Commerce
11. Department of Regional Economic Expansion (D.R.E.E.)
12. Ministère de l'Industrie, du Commerce et du Tourisme (Québec)
13. National Federation of Independent Business (United States)
14. Raymond, Chabot, Martin, Paré & Associés (Library)
15. Official Receiver, Montreal-Consumer and Corporate Affairs, Canada
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APPENDIX III

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APPENDIX IV

Annual Statistics on Bankruptcies in Canada

Type of Industry	Number of Cases				Total Assets				Total Liabilities			
	1978	1979	1980	1981	1978 (\$M)	1979 (\$M)	1980 (\$M)	1981 (\$M)	1978 (\$M)	1979 (\$M)	1980 (\$M)	1981 (\$M)
Primary Industries	146	199	311	427	6.9	7.2	21.5	42.7	15.4	28.8	44.4	76.3
Manufacturing Industries	393	538	532	681	23.7	19.8	40.9	43.8	64.5	69.4	95.5	172.0
Construction Industries	995	1,167	1,301	1,404	66.4	44.2	45.2	56.0	138.5	137.4	150.7	181.3
Transport, Communications and other public service utilities	286	345	431	551	5.4	7.4	18.5	13.0	14.6	21.4	34.3	45.2
Commerce (Wholesale & Retail)	1,882	1,894	2,120	2,560	56.0	61.0	78.0	102.6	178.1	164.2	209.6	279.2
Financial, Insurance & Realty	134	203	254	262	15.6	21.4	44.5	51.4	40.3	58.7	94.2	110.4
Services	1,710	1,348	1,646	2,170	62.3	47.3	50.5	77.8	186.9	137.2	154.3	281.7
TOTAL	5,546	5,694	6,595	8,055	236.3	208.3	299.1	387.3	638.3	617.1	783.0	1,146.1

Source: Office of the Superintendent of Bankruptcies.

APPENDIX V

Annual Statistics on Bankruptcies in Quebec

Type of Industry	Number of Cases				Total Liabilities			
	1978	1979	1980	1981	1978 (\$M)	1979 (\$M)	1980 (\$M)	1981 (\$M)
Primary Industries	27	30	80	106	3.5	3.6	13.8	16.9
Manufacturing Industries	145	247	245	297	35.2	39.5	52.0	113.4
Construction Industries	234	363	387	471	32.9	52.5	51.2	59.6
Transport, communications and other public service utilities	50	82	137	144	3.4	8.0	8.4	17.6
Commerce (wholesale and retail)	783	729	898	1,151	64.7	67.5	95.0	127.6
Financial, insurance and realty	28	62	85	92	3.0	13.3	22.0	39.3
Services	789	558	773	1,045	109.8	68.5	72.2	134.7
TOTAL	2,056	2,071	2,605	3,306	252.5	252.9	314.6	509.1

Source: Office of the Superintendent of Bankruptcies

APPENDIX VI

Annual Statistics on Bankruptcies in Ontario

Type of Industry	Number of Cases				Total Liabilities			
	1978	1979	1980	1981	1978 (\$M)	1979 (\$M)	1980 (\$M)	1981 (\$M)
Primary Industries	71	78	138	175	7.4	8.3	19.3	26.5
Manufacturing Industries	166	191	197	220	20.7	18.4	27.0	34.0
Construction Industries	391	477	612	578	45.2	47.0	57.1	69.9
Transport, communications and other public service utilities	143	136	165	226	6.3	5.9	11.0	14.6
Commerce (wholesale and retail)	711	710	804	886	53.5	54.0	70.1	85.5
Financial, insurance and realty	34	84	104	111	7.9	16.5	44.8	30.2
Services	625	555	602	705	51.6	45.5	58.5	80.5
TOTAL	2,141	2,231	2,622	2,901	192.6	195.6	287.8	341.2

Source: Office of the Superintendent of Bankruptcies

APPENDIX VII

Annual Statistics on Bankruptcies in Canada by Industry

Type of Industry	Number of Bankruptcies									
	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Primary Industries	---	---	---	---	---	---	---	148	200	312
Manufacturing Industries	447	434	399	346	358	457	511	392	534	532
Construction Industries	396	478	488	436	512	506	779	981	1,145	1,301
Transport, communications and other public service utilities	---	---	---	---	---	---	---	284	343	431
Commerce (wholesale and retail)	1,421	1,504	1,432	1,271	1,456	1,487	2,184	1,871	1,882	2,120
Financial, insurance and realty	---	---	---	---	---	---	---	133	203	254
Services	363	432	399	459	537	526	657	1,705	1,341	1,645
TOTAL	2,627	2,848	2,718	2,512	2,863	2,976	4,131	5,511	5,648	6,595

Source: Dun & Bradstreet, Canada

APPENDIX VIII

Annual Statistics on Bankruptcies in Canada by Province

Province	Number of Bankruptcies							
	1974	1975	1976	1977	1978	1979	1980	1981
Newfoundland	10	3	5	55	23	16	37	46
Prince Edward Island	3	--	4	6	11	4	6	20
Nova Scotia	29	62	75	88	96	71	91	164
New Brunswick	24	44	35	41	45	26	35	76
Quebec	872	971	966	1,349	2,047	2,039	2,605	3,306
Ontario	1,003	1,202	1,254	1,765	2,124	2,223	2,622	2,901
Manitoba	80	79	64	98	80	90	154	244
Saskatchewan	36	25	29	50	77	102	114	167
Alberta	177	193	192	121	323	380	445	619
North-West Territories & Yukon	--	--	--	--	8	11	4	11
British Columbia	278	284	352	558	677	686	482	501
TOTAL	2,512	2,863	2,976	4,131	5,511	5,648	6,595	8,055

Source: Dun & Bradstreet, Canada

APPENDIX IX

Bankruptcy by Age of Business in Canada in 1980

0-2 years	14.1%
2-5 years	41.0%
5-10 years	26.4%
10 years and over	<u>18.5%</u>
	100.0%

Source: Dun & Bradstreet, Canada

APPENDIX X

Insolvency Rate per 10,000 Canadian Businesses

1971	90
1972	98
1973	91
1974	78
1975	84
1976	82
1977	109
1978	124
1979	122
1980	131

Source: Dun & Bradstreet, Canada

APPENDIX XI

Annual Statistics on Bankruptcies in the U.S. by Industry

Type of Industry	Number of Bankruptcies						Total Liabilities (\$M)					
	1975	1976	1977	1978	1979	1980	1975	1976	1977	1978	1979	1980
Primary and Manufacturing	1,645	1,360	1,122	1,013	1,165	1,599	1,021	1,122	1,221	879	970	1,885
Commerce- wholesale & retail	5,888	5,167	4,293	3,629	4,091	6,194	2,243	971	1,096	1,123	1,058	1,585
Construction	2,262	1,770	1,463	1,204	1,378	2,355	641	428	420	328	291	752
Services	1,637	1,331	1,041	773	930	1,594	475	490	358	326	348	413
TOTAL	11,432	9,628	7,919	6,619	7,564	11,742	4,380	3,011	3,095	2,656	2,667	4,635

Source: Dun & Bradstreet (New York)

APPENDIX XII

Bankruptcy by Age of Business in the U.S. in 1980

0-2 years	10.5%
2-5 years	43.1%
5-10 years	28.1%
10 years and over	<u>18.3%</u>
	100.0%

Source: Dun & Bradstreet, (New York)

APPENDIX XIII

Insolvency Rate per 10,000 U.S. Businesses

1971	42
1972	38
1973	36
1974	38
1975	43
1976	35
1977	28
1978	24
1979	28
1980	42

Source: Dun & Bradstreet, (New York)

Appendix XIV

Questionnaire circulated to the members of the Canadian

Insolvency Association

Questionnaire

1. How many bankruptcies, without appropriation by the principal creditor of the business, have you dealt with in 1981?
2. How many appropriations by the principal creditor of the business, without subsequent bankruptcy, have you dealt with in 1981?
3. How many appropriations by the principal creditor of the business, followed by bankruptcy, have you dealt with in 1981?
4. In your opinion, which were the main reasons for small business bankruptcy and insolvency in 1981?

Interest rates:	%
Market saturation:	%
Federal Government policies:	%
Please give details:	%
Provincial Government policies:	%
Please give details:	
Fire or other damage:	%
Fraud:	%
Other:	%
Please give details:	
Total	100%

5. In your opinion, what action should the Federal Government take to help small business?
6. Other comments:

Thank you.

Appendix XIV

Questionnaire Circulated to Members of the
Canadian Insolvency Association

Raymond, Chabot, Martin,
Paré & Cie., Management
Consultants

January 13, 1982

Sir:

We are currently in the process of conducting a study for the Federal Government. A copy of the contract is hereto attached. Our client wishes to establish the scope and the reasons for the present small business crisis. Through the office of the Superintendent of Bankruptcies we have been able to assemble data relating to insolvency. We therefore ask for your cooperation.

Would you kindly complete the questionnaire attached and return it to us as soon as possible. Please rest assured that your reply and the results will be considered highly confidential.

Should you be interested in receiving a brief summary of the results of the study, please do not hesitate to call Stuart Attewell or Marco Fortier at (514) 878-2691.

Yours truly,

Stuart Attewell
Project Manager

SA:ldg

Quebec Insolvency Association
680 Sherbrooke Street W.
Montreal, Que., H3A 2S3

January 12, 1982

To the Members of the Quebec Insolvency Association:

Please find attached a questionnaire intended to obtain certain statistics on insolvency in Canada. This questionnaire has been formulated by the management consultants in the employ of Raymond, Chabot, Martin, Paré & Cie. who currently are conducting a study of insolvency for the Federal Government.

We are all aware of the persisting crisis in small and medium-sized business. Government intervention could have important direct or indirect repercussions on small and medium-sized business, as well as on trustees and insolvency agents. Given non-availability of information on insolvency, it seems to me all-important that we should cooperate in this study, thus allowing the government to reach its decisions on the basis of real and solid data.

A summary of the study will be forwarded to the Quebec Insolvency Association and to all the interested members. We are assured that those responding will remain anonymous. I therefore urge you to respond freely to the questionnaire.

Yours truly,

The President
Gérard Blais C.A.

Affiliated to l'ordre des Comptables Agrées du Quebec and the Canadian
Insolvency Association.

Appendix XV

List of twenty-two selected businesses

1. In the Montreal area.
 - Ameublement P. Gauthier Inc.;
 - Construction Domino Limitée;
 - Distribution Polaire Mirabel Inc.;
 - Drolet et Bouffard Limitée;
 - E and G Car Wash Service Limited;
 - Gregg Inc.;
 - Harbrook Wildoma Limited;
 - La Compagnie Martineau Electrique Limitée;
 - Les Equipements JNB du Canada Limitée;
 - ORU Canada Inc.;
 - Physika Limitée;
 - Quéabrique Inc.

2. In the Toronto region.
 - Agil Holdings Limited;
 - E and A Data System Inc.;
 - Mark Toys Canada Limited;
 - Multi Wall and Ceiling Systems Limited;
 - Murlan Industries Inc.;
 - Parco Apparel Inc.;
 - Speedy Tile and Carpet Contractors Limited;
 - Travnicek Building and Plumbing Limited;
 - 381519 Ontario Limited;
 - The company name has not been divulged to us.

Appendix XVI

Profile of twenty-two selected businesses

1. Insolvency	
Bankruptcies	9
Sequestrations	<u>13</u>
	22
2. Industrial sector	
Primary industries	-
Manufacturers	9
Construction	4
Transport, communications and other public service utilities	-
Wholesalers and retailers	5
Finance, insurance, realty	2
Services	<u>2</u>
	22
3. Age	
0-2 years	3
2-5 years	5
5-10 years	4
10 years and over	<u>10</u>
	22
4. Number of employees	
0-5 employees	3
5-10 employees	6
10-25 employees	4
25-100 employees	7
100 employees and over	<u>2</u>
	22
5. Turnover	
\$0-\$1 million	9
\$1-\$2 million	5
\$2-\$5 million	5
\$5-\$10 million	<u>3</u>
	22
6. Liabilities	
\$0-\$1 million	10
\$1-\$2 million	6
\$2-\$5 million	4
\$5 million and over	<u>2</u>
	22

7. Share capital issued (common stock)

\$1-\$1,000

4

\$1,000-\$10,000

12

\$10,000-\$50,000

3

\$50,000 and over

3

22

Appendix XVII

Interviewer's Guide

1. Person interviewed.

Name:
Place:
Date:
Firm:
Title:

2. General questions - Trustees and Bankers

- Your general opinion on the present crisis in small and medium-sized business.
- The filing for bankruptcy process.
- The appropriation process by the bank or other secured creditor.
- Relative importance of appropriations with respect to bankruptcies.
- General attitude of bankers and other creditors.
- General attitude of government agencies.
- 1982 Forecast.
- Government policies which should be adopted.

3. Case

Name of firm:
Address:
Owner or manager:

telephone number:

Bank:
Banker:

telephone number:

Trustee:
Sector:
Age:

1978 1979 1980 1981

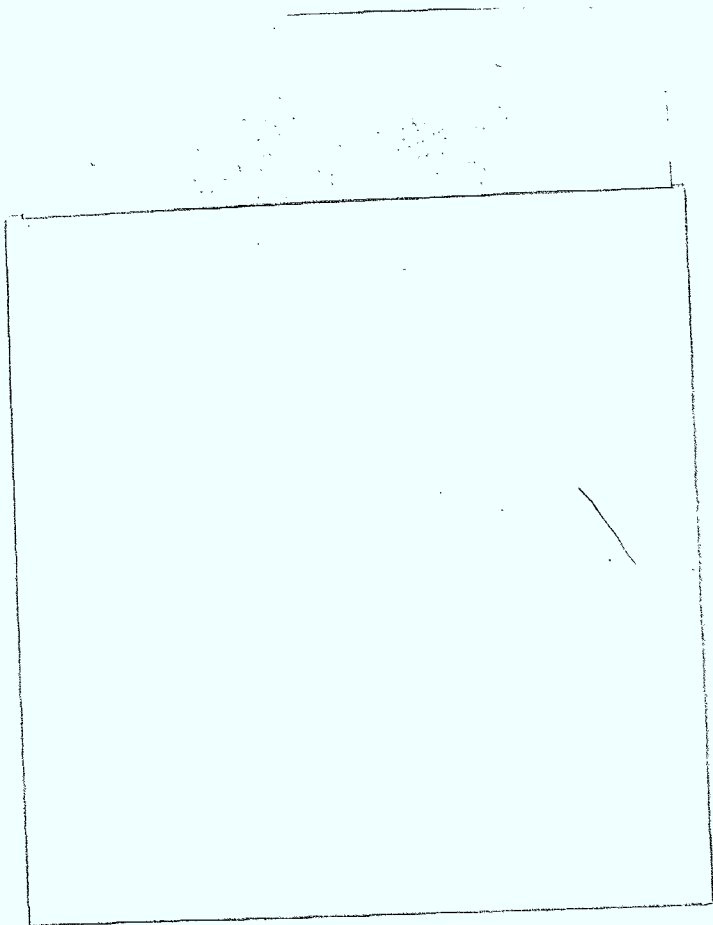
Turnover
Liabilities
Assets
Number of employees

- Creditors
- History
- Financing
- Reasons for failure
- The process
- Manager's profile
- Management style
- Government financial aid
- The bank's (or the creditor's) attitude
- Attitude (role) of trustee
- The means of avoiding failure

Appendix XVIII

List of persons interviewed.

1. In the course of our interview programme, from January 7 to March 4, 1982, we met fifty-nine (59) persons in the Montreal and Toronto areas.
2. Twenty-six (26) of the fifty-nine (59) persons were from the principal trustees' offices in the Montreal and Toronto areas:
 - Clarkson Gordon;
 - Coopers-Lybrand Ltd.;
 - Leon Friedman & Associates;
 - Peat Marwick Ltd.;
 - Price Waterhouse Ltd.;
 - Raymond, Chabot, Fafard, Gagnon Inc.;
 - Thorne Riddell Ltd.;
3. Twelve (12) of the fifty-nine (59) persons were from the most important Canadian chartered banks:
 - Royal Bank;
 - Bank of Montreal;
 - Canadian Imperial Bank of Commerce;
 - Toronto-Dominion Bank;
 - National Bank of Canada.
4. Eleven (11) of the fifty-nine (59) persons were owners or managers of eleven (11) of the twenty-two (22) businesses under study. Of the owners or managers of the eleven (11) other businesses, six (6) could not be reached and five (5) declined our invitation to collaborate in this study.
5. Among the other ten (10) persons interviewed there were:
 - Three (3) representatives of Office of the Bankruptcies Superintendent for Ottawa and Toronto.
 - Two (2) representatives of the Canadian Banker's Association.
 - One representative of the Canadian Creditors Association for the Revision of Rights and Legislations.
 - One representative of the Canadian Federation of Independent Business.
 - One professor of the École des Hautes Études Commerciales.
 - One representative of the Canadian Insolvency Association.
 - One representative of the Quebec Insolvency Association.



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