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Background Papers for the Bankruptcy and Insolvency Bill

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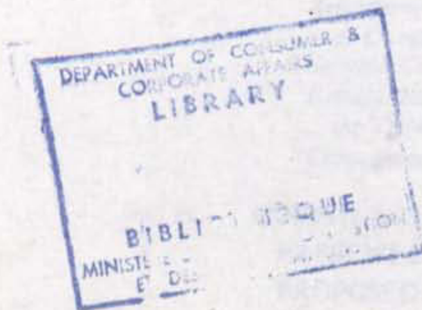
Consumer and Corporate Affairs

Consommation et Corporations

Background Papers for the Bankruptcy and Insolvency Bill



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BACKGROUND PAPERS FOR THE BANKRUPTCY AND INSOLVENCY BILL

INTRODUCTION

Enacted in 1949, the present Bankruptcy Act was amended in 1966, principally to enlarge the scope of the investigative powers of the Superintendent of Bankruptcy, to make more strict the rules relating to fraudulent preferences, and to add a new Part X concerning the Orderly Payment of Debts. Also in 1966, the government set up a Study Committee to review the bankruptcy system as a whole and to prepare a report recommending further amendments to the bankruptcy law.

The Study Committee's Report was submitted to the Minister of Consumer and Corporate Affairs in 1970 and was then widely distributed for comment. The Report recommended that the government, instead of making further amendments to the Act, present an entirely new bill that would contain more effective substantive rules and more efficient procedures, and that would integrate all federal insolvency laws in the one act. In the light of the Study Committee's Report and the comments received on it, the responsible officials of the Departments of Consumer and Corporate Affairs and Justice draftsmen have prepared the present Bill.

Concurrently with the preparation of the new Bill, the Bankruptcy Branch proceeded to implement a number of policy and administrative changes recommended in the Study Committee's Report that could be effected under the existing law. The Branch set up field bankruptcy offices in major centres across Canada, completed its program to substitute full-time bankruptcy officers as official receivers in place of the former court officials, and implemented a new program to make it possible for consumer debtors having few assets to invoke the bankruptcy process as a solution to their debt problems.

These interim measures have better enabled the Bankruptcy Branch to administer the approximately 3,000 commercial bankruptcies and 6,500 consumer bankruptcies that occur in Canada each year. Nevertheless the system created by the present Bankruptcy Act is still unnecessarily complicated, cumbersome and costly. It would almost certainly be inadequate to enable effective administration of the increased number of consumer arrangements projected to be made under the proposed law.

The proposed Bill is designed to remedy these problems. The policies set out in the Bill are described and compared part by part with the present law in the following summary.

PART I — INTERPRETATION

(Sections 1 – 10)

PRESENT LAW

Because it touches on all aspects of the law, the bankruptcy law includes within its scope a great many concepts and necessarily employs an extensive, specialized vocabulary. Although the present Bankruptcy Act contains some twenty-five definitions and a number of rules concerning related persons, because of a lack of precision in the language used, many of its substantive provisions remain unclear.

PROPOSED LAW

Part I of the Bill sets out roughly twice as many defined terms with a view to reconciling a

number of related civil law and common law concepts, clarifying a number of ambiguities that exist under present law, and condensing considerably the text of the Bill. The Bill also attempts to simplify and clarify the complicated rules defining related persons that are contained in the present Act.

Although a conscious effort was made not to embody substantive rules in defined terms, for the sake of drafting brevity — and to minimize ambiguity — it was found necessary to describe expressly in Part I a number of concepts. An important example is the declaration of what constitutes a "conflict of interest". Even more important are the refinements of the concepts "insolvent", and "ceased to pay his debts generally as they become due", which have been cast to make clear that it is a debtor's state of insolvency alone that makes the bankruptcy law applicable. Thus there will be no need, as under present law, to prove in addition to insolvency an "act of bankruptcy", an archaism in the law carried over from the time when application of the bankruptcy law connoted punishment for a specified breach of commercial morality. To underline both their complexity and their importance throughout the Bill these concepts are set out in distinct sections.

The Bill also includes a definition of the concept of "security interest", which in effect abrogates the title or lien theories that still exist in a number of Canadian jurisdictions, and substitutes instead a functional test, similar to that of the Ontario Personal Property Security Act, which, to determine a creditor's rights in property of a debtor, requires a court to scrutinize the real nature of the transaction between the debtor and secured creditor irrespective of any reservation of ownership in the creditor. The generic concept of a security interest will render it impossible for creditors to escape the application of the bankruptcy law simply by characterizing their transactions with the debtor as leases or conditional sales.

PART II — ADMINISTRATION

(Sections 11 – 62)

General

The specific objectives of the federal bankruptcy law are quite straightforward: to provide an effective means to collect and liquidate a debtor's assets; to ensure equitable distribution of the proceeds realized from those assets among the creditors of the debtor; and, where feasible, to rehabilitate the debtor as a useful member of the community. In short, the bankruptcy law aims to maintain a reasonable balance of interests among debtors, creditors and the public generally. But in order to achieve these objectives the bankruptcy law may affect legal institutions that exist in both the civil and common law systems and modify them to a certain extent.

The bankruptcy law is therefore inherently complicated. It sets out a large number of substantive rules concerning the respective property and contractual rights of creditors among themselves and in relation to the debtor. These rules are, however, only ancillary to the central purpose of the bankruptcy law, which is to set up a uniform, effective administrative system to deal with the affairs of insolvent debtors. It is for this reason that the administrative structure embodied in the bankruptcy law is correctly characterized as the foundation of the bankruptcy system.

The five principal elements of this administrative structure are the Superintendent of Bankruptcy, the official receiver (called the "Bankruptcy Administrator" in the Bill), the courts, the trustees, and the creditors.

PRESENT LAW

Superintendent of Bankruptcy

At the centre of the administrative structure is the Superintendent of Bankruptcy, who is responsible to make recommendations in respect of the licensing of trustees, to direct audits and to

evaluate the performance of trustees, to maintain surveillance over estates, to detect any improper or unlawful acts, to investigate suspected offences against the Bankruptcy Act or any other federal statute, and to administer the small debtor program that was begun in 1972. Since 1966 the Department of Consumer and Corporate Affairs has set up regional and local bankruptcy offices in major centres across Canada through which the Superintendent carries out most of his estate surveillance, detection, investigation and small debtor administration functions.

Official Receiver

Although an insolvent debtor may initially seek advice from a trustee or a lawyer, his first formal contact with the administrative process is with the official receiver. Official receivers are appointed by the Governor-in-Council for each bankruptcy division (province) and are officers of the court. The duties of the official receiver are to accept the debtor's assignment, to appoint the trustee in the estate and to set an estate bond to be filed by the trustee, to chair the first meeting of creditors in bankrupt estates, and to examine the debtor in respect of his affairs.

Courts

In addition to the judicial function of resolving conflicts in adversary proceedings, the Act imposes responsibility on the Court to distinguish between the unfortunate debtor and the conniving one, and accordingly to exercise its power to release or discharge the debtor from his debts and from his status of bankrupt. The Court is also required to tax the accounts of trustees and solicitors acting for the estate and to perform other tasks which are primarily administrative rather than judicial in nature. Generally, the registrar of the Court conducts most of the non-contentious business.

Trustee

The Bankruptcy Act requires that the property of each bankrupt estate be vested in and administered by a licensed trustee, a legal structure that is analogous to the common law system for the administration of estates of a deceased person. To qualify as a licensed trustee, a candidate must demonstrate a thorough knowledge of bankruptcy law and its application and have satisfactory financial and other resources available to administer estates under the Bankruptcy Act.

The statutory responsibility of the trustee is to administer the affairs of the bankrupt estate. This administration includes the preparation of an inventory, gathering in and realizing assets, liquidating assets, distributing the proceeds in accordance with the Bankruptcy Act, and rendering a final account of the administration to the creditors and the court.

Creditors

Finally, the Act envisages an important role for creditors who, at the first meeting, would normally nominate a board of inspectors. These inspectors are required to maintain policy control over the administrative decisions of the trustee. With the exception of the larger estates, it generally is found that creditors tend to ignore the first meeting of creditors and so impose upon the trustee nominated by the official receiver the duty to administer the estate without the benefit of a board of inspectors.

PROPOSED LAW

General

Part II introduces a number of policies that are reflected repeatedly throughout the Bill. It attempts as far as possible to separate the judicial and administrative functions now exercised by the courts, expressly assigning the administrative functions such as taxing trustees' and solicitors' accounts to Bankruptcy Administrators. It sets out an administrative structure that better reflects the real exercise of functions and permits greater administrative efficiency, particularly by dealing with specific issues on an exceptions basis

wherever possible; e.g., by requiring a creditor to file a proof of claim only where the trustee's statement of claims is incorrect, or by requiring the bankrupt to apply formally for discharge only where a caveat is filed. Part II also facilitates a broad delegation of authority from the Superintendent to local Bankruptcy Administrators to ensure closer contact with the interested parties and greater sensitivity to local conditions.

In addition, Part II sets out rules concerning the bonding of trustees and conflicts of interest, expanding on the latter concept as described in Part I (Interpretation).

The conflict rules in effect constitute a conflict of interest code to govern the qualification and conduct of trustees, inspectors, solicitors and others involved in the administration of an estate. Certain persons are rendered ineligible to be appointed or to act as trustees. Generally these persons include those who were closely related to the debtor during the two years immediately preceding the bankruptcy or arrangement, e.g., partners, officers, employers and employees of the debtor; those related to an officer of the debtor where the debtor is a corporation; auditors, accountants and solicitors of the debtor; and persons acting as trustees or related to a trustee acting under a trust indenture. In special circumstances, where it is in the best interests of creditors, the Court may allow persons having a conflict of interest to act in the administration of an estate. A trustee who has or may have a conflict of interest is required to apply to the Court for directions.

At present a trustee is required to put up three kinds of security to ensure that he faithfully performs his duties as trustee. First, upon receiving a licence, a trustee is always required to deposit with the Superintendent of Bankruptcy a fidelity bond issued by an insurance company. In addition, the trustee is required to deposit with the Superintendent, government or government guaranteed bonds in an amount that is fixed by policy and that varies according to the number and size of the estates the trustee administers. Finally, the official receiver also requires a trustee to furnish a fidelity bond in respect of each estate he administers. This bonding system has proved to be expensive. Moreover, the Superintendent has experienced difficulties when attempting to recover under the fidelity bonds where a trustee is found to be in breach of his fiduciary duty.

To overcome these difficulties an Indemnity Account is proposed, which would be financed by fees paid by trustees, interest earned on moneys deposited in banks that cannot be identified as belonging to particular estates, and moneys recovered in satisfaction of any claim paid out of the Indemnity Account. Any person who obtains a judgment against a trustee on grounds of a breach of fiduciary duty will be entitled to be indemnified out of the Account.

Superintendent

The present functions of the Superintendent continue substantially unchanged. He will, however, have more direct and broader responsibilities in a number of areas. Instead of making licensing recommendations to the Minister, the Superintendent is empowered to decide issues concerning the licensing of trustees, subject only to judicial review of that particular administrative action under the Federal Court Act. His powers of detection and investigation are expanded to encompass arrangements as well as bankruptcies. Also, he is responsible to hear appeals with respect to the taxing of a solicitor's or accountant's bill rendered in connection with the administration of an estate.

Bankruptcy Administrator (former Official Receiver)

The local bankruptcy official is called the "Bankruptcy Administrator" in the Bill, first because that name is more descriptive of his functions, and second because the phrase "official receiver" wrongly connoted that property vested in the bankruptcy official. In fact, the property of a bankrupt's estate vests only in a trustee.

The Bankruptcy Administrator continues under the Bill to be responsible to carry out what were the functions of the official receiver, particularly those administrative functions such as accepting copies of and recording petitions, examining debtors, and chairing first meetings of creditors. In addition, under the Bill, the Bankruptcy Administrator has a duty, where he is of the opinion that a debtor caused his bankruptcy by rash or hazardous speculation, reckless business conduct or other abuses of the credit system, to file a caveat within 90 days after the date of bankruptcy and so block the discharge of the debtor.

The Bankruptcy Administrator will also be empowered to prepare and administer small debtor arrangements, whether by way of composition or extension. Also, he will be required to administer consumer bankruptcies and may administer a commercial bankruptcy where no private sector trustee will undertake administration of the particular estate.

Courts

As stated above, one of the main policies of the Bill is to transfer from the courts to Bankruptcy Administrators administrative functions such as the taxing of accounts and the discharge of bankrupts. It is to be noted, however, that legal fees resulting from court proceedings would still continue to be taxed by the courts. To achieve consistent application of policy across Canada in respect of passing estate accounts submitted by solicitors and accountants, the local Bankruptcy Administrators will carry out these functions under the general supervision of the Superintendent. A trustee or interim receiver may appeal a Bankruptcy Administrator's decision to the court; a solicitor or accountant may request the Superintendent to review an Administrator's decision and, if still dissatisfied, may appeal to the court.

Consistent with the general administration by exception policy of the Bill, a bankrupt will be automatically discharged 90 days after the date of bankruptcy except where a Bankruptcy Administrator files a caveat to block such discharge. The bankrupt may apply to court to have the caveat set aside or removed on the ground that he has rehabilitated himself and that the public interest no longer requires that he be barred from doing business on credit. Thus the court considers discharge only in exceptional cases.

Trustee

Although the Bankruptcy Committee Report had recommended substituting public sector trustees for private trustees, after considering comments on the Report, the government concluded that the Bill should continue to assign responsibility for the administration of commercial bankruptcies to private sector trustees because private sector trustees are better equipped to react to emergency situations. There are a number of provisions in the Bill that are intended to clarify the rights, duties, liabilities and powers of trustees, but in general their functions and responsibilities under the Bill are the same as under the present law.

Also, continuing present policy, public sector trustees, i.e., "federal trustees" will be restricted to handling small debtor estates, consumer bankruptcies and commercial estates that no private sector trustee will undertake to administer.

Creditors

Because creditors actually realize, on average, only a small percentage of their claims against bankrupt estates, they are reluctant to commit further resources directly to administer those estates. As a result, most administration is left almost entirely to the trustee, subject only to the surveillance of the Superintendent. Thus creditors will continue to be reluctant to participate; nevertheless by making the functions of creditors and inspectors clearer and by rendering administration more efficient, the Bill attempts to induce the creditors to play a more active role.

PART III — ARRANGEMENTS FOR THE CONSUMER DEBTOR

(Sections 63 – 89)

PRESENT LAW

The commonplace use of revolving accounts, credit cards and institutional consumer lending services made available during the past twenty years has made virtually every Canadian a user of credit and, as a corollary, has led to an enormous growth in the aggregate amount of consumer debt outstanding. Given the aggressive efforts of lenders to promote their credit services, it is not surprising that an increasingly large number of householders become seriously overburdened by debts they cannot repay, particularly where the household is affected by some unforeseen catastrophe.

Under the present Bankruptcy Act an insolvent consumer or wage earner debtor may resort to bankruptcy for relief from his debts, but until mid-1972, this remedy was often illusory, since in many cases he did not have sufficient funds (approximately $500) to secure the services of a licensed private trustee to administer the estate as required by the Bankruptcy Act. In 1972 the government, by a decision of Cabinet, introduced the Small Debtor Program to assist wage earner debtors with low income and little property (generally, maximum annual income $5,000; maximum property $2,000), who are unable to obtain the services of a private trustee. Under this program, a public servant licensed as a trustee by the Superintendent of Bankruptcy administers the estate for a nominal fee or even for no fee in certain cases. From a limited start, this program is now available across Canada, and is administered by federal trustees located in 14 centres. It is not available to self-employed persons or to persons with business debts.

An insolvent consumer or wage earner debtor who wishes to avoid the social stigma of bankruptcy may choose to make a Proposal to his creditors under Part III of the present Act in the same way as a commercial debtor. This remedy, again, is largely illusory because most consumers who are in financial difficulty cannot afford the services of a private trustee. Furthermore, the mandatory procedures of the present Act, which were designed for insolvent businesses, are too cumbersome to permit efficient administration of arrangements for consumer debtors.

A third remedy available to the insolvent consumer debtor is debt consolidation under Part X of the present Act. That Part was enacted in 1966 as a result of a decision of the Supreme Court of Canada that similar legislation enacted by Alberta in 1956 was not valid because it was primarily bankruptcy and insolvency legislation and therefore exclusively a federal matter. Part X provides for a simple and inexpensive procedure whereby specified insolvent debtors, who are not in business, may apply to the clerk of the Court for a consolidation order. The debtor undertakes to pay fixed amounts to the Court for distribution among creditors until all his debts are paid in full. In sum, this Part legitimates only an extension of time to repay, not a composition that effects a rateable reduction of creditors' claims. Moreover, Part X is only in force in those Provinces which request it. Only six Provinces, not including Ontario and Quebec, have implemented Part X. Thus a large number of Canadians are denied access even to this limited form of relief.

PROPOSED LAW

Arrangements

Because of the shortcomings of the present Bankruptcy Act, Part III of the Bill proposes two forms of arrangements for consumers and small businessmen. These arrangements complement relief under bankruptcy proceedings, which are viewed as a last resort solution. Those debtors who sincerely want to pay their debts in full may make an arrangement by way of extension; those who are unable to pay in full but are willing to pay as much as they can in order to avoid bankruptcy, may make an arrangement by way of composition. The maximum duration of both types of arrangement is 3 years, but in special circum-

stances the Bankruptcy Administrator is authorized to extend the period by one year. No debtor can be compelled to choose an arrangement instead of seeking complete discharge through bankruptcy proceedings, but the requirement that he surrender almost all of his property to his trustee if he elects for bankruptcy will be a strong inducement to make him prefer an arrangement.

As soon as the debtor files a request with a Bankruptcy Administrator to formulate a proposal, every creditor who would be affected by the proposal is barred from exercising any remedy against the debtor or his property or instituting or continuing an action for the recovery of his debt until the debtor withdraws the request, the creditors reject the proposal, the Court specifically authorizes a creditor to act, or the arrangement is annulled.

Arrangement by Way of Extension

Under this type of arrangement, because their claims are paid in full, the creditors have no power to reject the arrangement and hence there is no purpose in calling a meeting of creditors. Creditors will simply be notified of the proposed arrangement. They are entitled, however, to file an objection with the Bankruptcy Administrator with respect to the terms of the arrangement and to request a hearing before the Administrator. After considering their objections, the Administrator may continue the proposed arrangement unchanged or modify it as he thinks fit better to satisfy objecting creditors within the limits of the debtor's ability to pay.

Arrangement by Way of Composition

In this type of arrangement, each creditor is entitled to receive only a rateable part of his claim over a period of time. Thus a composition can encroach seriously upon a creditor's rights. The Bill therefore empowers the creditors by simple majority resolution to reject the proposal. To enable the creditors to exercise this power the Bankruptcy Administrator is required to call a meeting to ascertain their wishes. The quorum is fixed at one creditor entitled to vote at meetings. If a meeting is held, or if no creditor turns up within half an hour of the time fixed for the meeting, the proposal is deemed to be accepted as made unless it is rejected or amended by the vote of a majority of creditors entitled to vote, whether or not they are present or represented at the meeting.

Secured Creditors

With the exception of creditors whose claims are secured by real property, all secured creditors are bound by a consumer arrangement. However, in the case of an arrangement by way of composition, creditors who have a security interest in personal property, if more than one-third of the original purchase price is outstanding, may elect within 20 days after a notice has been sent to them by the Bankruptcy Administrator not to participate in the arrangement. If they do elect not to participate, their rights are confined to their security interest and their claim against the debtor or his estate for any deficiency balance is barred. In the case of an arrangement by way of extension, the right to elect not to participate exists only if the security was given less than 60 days before the date of the proposed arrangement.

Rehabilitation of the Debtor

The Bill, by creating a strong incentive to enter into an arrangement instead of bankruptcy, emphasizes debtor rehabilitation through better financial planning. In any case, the Bill requires the Bankruptcy Administrator to exercise such supervision and give such advice to the debtor as will assist him to rehabilitate himself financially and carry out his financial obligations. The Bankruptcy Administrator may refer the debtor to guidance and counselling agencies in the community. As one of the rehabilitative measures, he may also permit the debtor, after an arrangement has been in effect for at least 6 months, to make payments directly to the creditors if the Administrator is satisfied that the debtor is able to manage his financial affairs.

Consequences of Default

Where a debtor fails to comply with the terms of an arrangement the Court may annul it. If he defaults for more than 3 consecutive months, the arrangement is deemed to have been set aside and all the rights of creditors revive, including any right to repossess or seize in execution the assets of the debtor. There is no automatic bankruptcy, but of course a defaulting debtor may petition himself into bankruptcy. After a debtor defaults under an arrangement, he is not entitled, without leave of the Court, to make another proposal for an arrangement unless all debts which were part of the previous arrangement are paid.

If an arrangement is not a satisfactory solution, any debtor has a right to go into voluntary bankruptcy. The Bankruptcy Administrator will continue to assist those debtors who elect bankruptcy but cannot afford the services of a private trustee.

PART IV — COMMERCIAL ARRANGEMENTS

(Sections 90 – 125)

PRESENT LAW

Bankruptcy and insolvency laws have long recognized that a firm may get into short term financial difficulties because of a general economic crisis or a sudden change of market conditions that is clearly beyond the control of the firm. If a firm cannot survive the rigours of competition in the long run, then the bankruptcy law should make it possible to liquidate and dissolve that firm with a minimum of formality and cost, freeing its capital to be used by another enterprise. But where a firm is viable, if bankruptcy were the only solution to short term difficulties, then the bankruptcy law itself would tend to be forcing a less than optimal use of economic resources. The present federal laws therefore facilitate and even encourage proposals for commercial arrangements.

Proposals, more properly called proposals for an arrangement, may be made at present under one or more of several federal statutes. Most proposals relating to unregulated business corporations are made under Part III of the present Bankruptcy Act, but such corporations may also make a proposal under the Winding-Up Act or the Companies Creditors' Arrangement Act. The Bankruptcy Act does not apply to banks and other financial intermediaries, which can therefore make proposals only under the Winding-Up Act or the Companies Creditors' Arrangement Act. Railway companies may make an arrangement only under certain vestigial provisions of the Exchequer Court Act.

A proposal under the present Bankruptcy Act may be filed by a debtor before or after he is bankrupt. When a debtor files a proposal, no creditor affected by it may institute or continue any action or proceeding to enforce a claim. However, secured creditors are not affected by the proposal, and creditors whose debts are not dischargeable, such as suppliers of necessaries, are not bound by it. Furthermore, the proposal must provide for payment in full of the claims of creditors having a priority under the Act, and for the payment of the trustee's fees and disbursements. In order to bind unsecured creditors, the proposal must be accepted by a majority of them representing three-fourths in value of claims and must also be approved by the Court.

One of the great merits of a proposal is that the debtor continues to manage his business unless the proposal states otherwise or the creditors, with the consent of the debtor, impose conditions. Unlike bankruptcy, the debtor's property does not automatically vest in the trustee.

If a proposal is rejected by the creditors or by the Court, or if after it has been accepted and approved it is annulled by the Court for default or for other reasons, the debtor is deemed to be bankrupt. To ensure that debtors do not abuse the privilege of making proposals and thus stall inevitable bankruptcy, the Bankruptcy Act was

amended in 1966 to make the automatic bankruptcy retroactive to the date of filing a proposal (except where the proposal is annulled by the Court). The aim of this retroactive provision is to enable the trustee to recover fraudulent dispositions, including preferential transfers, made by the debtor within the prescribed delay periods, which are calculated retrospectively from the filing date.

Proposals under the Companies Creditors' Arrangement Act are generally made with respect to creditors who hold debentures issued under a trust indenture. The now obsolete Farmers Creditors' Arrangement Act authorized the Court to formulate a proposal for a farmer. In contrast, under the Bankruptcy Act no person other than the debtor can make a proposal.

The Bankruptcy Act requires the trustee to make an appraisal and investigation of the affairs and property of the debtor to enable the trustee to estimate with reasonable accuracy the financial situation of the debtor and the cause of his financial difficulties or insolvency, and to report the result of his enquiry to the meeting of creditors. The debtor must also submit a copy of the trustee's report to the Court when he seeks the required court approval of the proposal. But the present Act does not require the debtor to disclose details of payments made or promised to be made by him to the trustee for future services or to other parties outside of the terms of the proposal itself.

PROPOSED LAW

The primary object of Part IV of the Bill is to provide a new, integrated and flexible procedure to facilitate a wide variety of arrangements. However, banks and other financial intermediaries such as trust companies, credit unions, and insurance companies are not permitted to take advantage of this Part. This prohibition reflects the policy conclusion that if a financial intermediary is in such serious trouble that it must resort to an arrangement with creditors it should not, in the public interest, be permitted to continue in business.

Notice of Intention

The Bill recognizes that it is in the interest of creditors that the debtor has reasonable time to prepare a carefully considered and workable proposal for an arrangement, free from pressure or harassment. It therefore allows the debtor to file a Notice of Intention with the Bankruptcy Administrator stating that he proposes to file a proposal with a view to preventing bankruptcy. If the debtor files this Notice, all legal proceedings against him by creditors who would be affected by the proposal are automatically stayed for a period of 10 days. However, after the filing, the debtor cannot deal with his property, other than in the ordinary course of business, without the consent of the interim receiver or trustee named in the Notice.

To obtain further immunity from legal proceedings, the debtor must file a proposal within the stipulated time. If he fails to do so within 10 days after the Notice is filed, any creditor may petition the Court for a bankruptcy order against the debtor.

Persons Entitled to Make a Proposal

In addition to the debtor himself, where a bankruptcy order has been made against a debtor or where a corporation is being dissolved, the Bill permits the trustee in bankruptcy or the liquidator of the corporation, as the case may be, to make a proposal in respect of the debtor. Furthermore, any creditor or any trustee appointed under a trust indenture is entitled to make a proposal for a debtor who is bankrupt, or is in the process of being dissolved or liquidated.

Required Provisions of a Proposal

The Bill makes it mandatory for the debtor to disclose all payments made or promised to be made by him to the trustee and others in connection with the proposal, including pay-

ments to be made outside of the proposal. The debtor must also clearly set out the amount and terms of payment, including the grant of any security interest to secure payment, that he proposes to make. If the proposed arrangement is to be guaranteed, it must also set out the terms of the guarantee.

Duties of the Trustee

The Bill places additional duties on a trustee who agrees to carry out a proposal. His investigation into the debtor's affairs must be adequate to enable him to arrive at an opinion and to report to the creditors that the debtor has dealt fairly with them and that the debtor has not entered into transactions or disposed of property in fraud of his creditors. In sum, the trustee must exercise the same vigilance in respect of preferential and reviewable transactions as he would if a bankruptcy order had been made against the debtor and bring any such facts to the notice of the creditors.

Formulation of Proposals by Court

The Bill also permits Court formulated proposals, adopting a feature of the Farmers Creditors' Arrangement Act. Recognizing that a firm may be the life blood of a community, the Bill empowers the Court to formulate a proposal in respect of a debtor whose debts exceed one million dollars, if the Court is of the opinion that in the public interest all efforts should be made to continue the firm in business rather than dissolve it through the bankruptcy process. The Court may, however, decline to formulate a proposal where the proposal would not be just and equitable to the creditors.

PART V — BANKRUPTCY

(Sections 126 – 223)

PRESENT LAW

The law applicable to insolvent debtors is now set out in several federal statutes. The Bankruptcy Act applies to all individual and corporate debtors other than financial intermediaries and railway companies, which are subject to specific insolvency provisions set out in the respective regulatory acts that apply to them. The Winding-Up Act applies mainly to the liquidation and dissolution of solvent business corporations but can also apply to any insolvent corporation, whether incorporated federally or provincially. An insolvent corporation, however, can be compelled to be wound up under the Bankruptcy Act. These repetitive and frequently overlapping insolvency laws engender much uncertainty and confusion.

Commencement of Bankruptcy Proceedings

The present Bankruptcy Act does not give any relief to a small debtor whose total liabilities do not exceed one thousand dollars. Nor does it permit anyone who is not a creditor to initiate any action when he becomes aware that a debtor is in financial difficulties. This exclusive reliance on creditors often defeats the purposes of bankruptcy law, especially where creditors are unaware that the debtor is attempting to save himself from utter ruin or to preserve for himself, at their expense, as many of the unencumbered assets as possible. As a result, it does not adequately protect the public interest.

Stay of Proceedings

To prevent a scramble among creditors, the Bankruptcy Act, upon the filing of a petition, automatically stays any legal proceedings against a bankrupt except where a Court expressly permits such proceedings to be initiated or continued. But this automatic stay generally does not affect secured creditors whose rights may be postponed only by an order of the Court and then only for a period not exceeding six months. A secured creditor may often realize his security interest by prompt repossession and disposal of the debtor's property even before being restrained by Court order, thus leaving little or nothing for other creditors. In contrast, the Winding-Up Act stays all legal proceedings by

creditors to enable the liquidator to obtain a complete overview of the debtor's affairs.

Exempt Property

Under the present Bankruptcy Act a debtor may retain certain property that provincial legislation has declared to be exempt. The nature and extent of such exemptions vary widely from province to province. Although one may justify exemptions on the ground of common humanity, this wide variation is often unjust and discriminatory. Also under the present Act the trustee may claim a part of the bankrupt's earnings or property acquired by him before his discharge.

Discharge of the Bankrupt

The filing of an assignment by and the making of a receiving order against an individual automatically operates as an application for his discharge from his status as a bankrupt, but in order that debts and liabilities may be released, the Court must make a formal order of discharge. Upon hearing an application for discharge, a Court has power to suspend a discharge or to impose conditions on the bankrupt. The practice of granting discharges varies widely across the country. Debtors often fail to obtain a discharge, and as a result continue to have the status of bankrupt and to be subject to a bankrupt's civil disabilities, particularly the bar against carrying on business on credit. Corporate bankrupts must apply formally for discharge, which is granted only if creditors' claims are paid in full, a case that rarely occurs.

The status of bankrupt to which a corporation is subject, however, does not affect the human agents — the directors and officers — who control it; they are free to embark upon new ventures almost unblemished by the status of the corporation they managed. The only exception is the report, introduced by the 1966 amendments, that is prepared by the trustee and filed with the Superintendent of Bankruptcy and with the official receiver, which may impute blame for the bankruptcy to named directors and officers. Although the report is available to the public, it is seldom effective to control the activities of persons who were responsible for the bankruptcy of a corporation, and it is grossly inadequate to cope with the problem of "planned bankruptcies".

Avoidance and Review of Transactions

Both the Bankruptcy Act and the Winding-Up Act contain provisions designed to enable the Court to set aside gifts, settlements and fraudulent preferences occurring within certain time periods before a bankruptcy or corporate dissolution. The provisions relating to fraudulent preferences, empowering a Court to set aside payments made to a creditor if the debtor intended to prefer him to others, are relatively ineffective because it is often very difficult to prove that the debtor had an intent to prefer. Complicating the matter further, some Courts require an intention both of the debtor to give and of the creditor to receive a preference. The provisions of the Winding-Up Act set out more objective criteria; they parallel provincial laws on the subject which, in cases where federal legislation is not broad enough, have frequently been invoked with some success to attack preferences.

PROPOSED LAW

The Bill sets out a comprehensive bankruptcy and insolvency system, integrating in one statute the usual insolvency provisions, which will now apply not only to ordinary business firms but also to insolvent financial intermediaries, stockbrokers, and railway companies, thereby obviating the repetitive and overlapping provisions that now exist in the federal laws. In addition, the Bill introduces a number of important innovations relating to bankruptcies that are designed to render the proposed law clearer, fairer, and easier to administer.

Commencement of Bankruptcy Proceedings

Any person or corporation, without limitation as to the nature of his occupation or the amount

of debt, may apply for a bankruptcy order in respect of himself. One or more unsecured creditors having aggregate claims in excess of $1,000 may also petition a debtor into bankruptcy. A corporation found to be insolvent when it is being wound up under any other legislation, for example, a corporation law, must be brought within the framework of the bankruptcy statute. Specific rules apply to partnerships, stockbrokers and insurance companies.

Also, where a department or agency of the federal or a provincial government exercises regulatory or supervisory authority over the financial affairs of a debtor, it may initiate bankruptcy proceedings in respect of the debtor through the appropriate Attorney General where necessary for the protection of the public interest.

Stay of Proceedings

Following the policy of the Winding-Up Act, the Bill stays all proceedings against a debtor, including proceedings by secured creditors. With respect to an unsecured creditor's claim, the stay, continuing the policy of the present Bankruptcy Act, is absolutely binding on the creditor unless the creditor is expressly excepted by Court order. With respect to a secured creditor's claim two innovations are set out in the Bill to enable the trustee better to evaluate the overall condition of the debtor's affairs and to plan his administration accordingly. First, each secured creditor is required to file a notice of security interest with the trustee to ensure that the trustee is aware of all secured creditor claims. Second, a secured creditor's rights to deal with the property of the debtor are, except in respect of perishable property, stayed for thirty days to give the trustee time to elect whether he should redeem or realize that property or surrender it to the creditor. Specific rules govern the conduct of the trustee in each case, depending upon the election he makes.

Government creditors, whether the Crown in right of Canada or a province or a subordinate agency, are in nearly all circumstances treated like all other creditors. If a government creditor makes a claim as a secured creditor it must file a proof of security interest showing that it has perfected its security interest in the same manner — by registration or otherwise — as any other secured creditor is required to perfect his security interest.

Exempt Property

Continuing the policy of the present Act, property held in trust, property that is exempt from seizure under a provincial law, and disablement benefits do not vest in the trustee. Also, as a general rule, wages and property acquired by a bankrupt before he is discharged do not automatically vest in the trustee; but where the bankrupt earns an income in excess of $500 per month or acquires by gift or otherwise property in excess of his reasonable requirements the trustee may apply to the Court for an order vesting the excess in him for distribution among the creditors.

To ensure that provincial law cannot discriminate in favour of provincial residents, the Bill sets a maximum ceiling of $3,000 (or such greater amount as may be prèscribed by regulation) on total exemptions. If a bankrupt elects to retain exempt property in excess of $3,000 he will not be discharged until he repays his creditors in full or at least in part under a composition arrangement to which a majority of the creditors have agreed.

Discharge of the Bankrupt

When a bankruptcy order is made in respect of a debtor, the debtor is released from all his debts except a fine, an obligation in respect of a bail bond or recognizance, or an obligation to pay family maintenance. Also, he is not released from a debt he failed to disclose to the trustee, but his continuing liability is limited to the amount the creditor would have received had the trustee known about the claim.

Consonant with the administration by exception policy of the Bill, a debtor is not required to

apply to a Court for a discharge. A corporate bankrupt can be discharged only if it pays all its debts in full. An individual bankrupt is automatically discharged 90 days after the date of the bankruptcy order affecting him unless he keeps exempt property in excess of $3,000 or unless a Bankruptcy Administrator files, within that 90 day period, a caveat stating he has reason to believe that the bankrupt substantially aggravated his insolvency by reckless business conduct, gross incompetence or carelessness or similar means, or that he has committed specified bankruptcy offences. The Administrator may withdraw the caveat at any time after 90 days from the date of the bankruptcy order, or the Court may set it aside. If not withdrawn or set aside the caveat has effect for 5 years, thus hindering the bankrupt from obtaining credit to carry on business and continuing his liability to the estate for excess wages or excess after-acquired property.

With a view to promoting the integrity of the credit system, the Bill empowers the Court to revive all debts from which a bankrupt has been released within 5 years of his current bankruptcy, if the Court is of the opinion that the bankrupt has abused the bankruptcy process to the detriment of the creditors.

Directors and Officers of Corporations — Liability and Discharge

The Bill introduces several new provisions concerning the status and personal liability of directors and officers of corporations. First, the Bill prohibits a bankrupt from continuing to act or from being elected or appointed as a director of a corporation. And second, the Bill imposes personal liability on directors and officers and former directors and officers (within 2 years before the bankruptcy) for debts of the corporation that remain outstanding as claims against the estate, where the director or officer has in his own interest — and hence in breach of his fiduciary duty to the corporation — continued to carry on a business that was not in the interest of the corporation, continued to carry on business by resorting to sales below cost or similar improper means, conducted business with a view to delaying or defrauding creditors, or committed specified bankruptcy offences. A director or officer is also personally liable for outstanding corporate debts if he fails to keep accounts that enable the trustee to distinguish between the corporation's property and the property of the director or officer.

In addition to or instead of imposing personal liability, a Court may declare a director or officer who is guilty of the misconduct described above to have a qualified status as a bankrupt, hindering him from obtaining credit to carry on business, but not, as in the usual case, making his excess earnings and excess after-acquired property available to creditors having claims against the estate of the corporation. Where a Court makes such an order, the affected director or officer continues to have that qualified status as a bankrupt for 5 years from the date of the bankruptcy order made in respect of the corporation or until the bankruptcy order is annulled or the corporation pays its debts in full.

Avoidance and Review of Transactions

The Bill sets out a comprehensive code in respect of fraudulent transfers and preferential payments in respect of both arm's length and non-arm's length transactions. The purpose of the code is to include as far as possible those transactions that have the effect of defeating the legitimate expectations of honest creditors. It attempts to achieve this purpose by extending the provisions in the present Bankruptcy Act, by eliminating difficult subjective tests which require the trustee to prove that the debtor intended to prefer a creditor, and by bringing the law more into conformity with prevailing business practices.

With respect to transfers that have the effect of giving a preference to a creditor, the Bill distinguishes between a transfer made by persons who deal with each other in an accepted business manner and a transfer made by persons who do not so deal with each other. In the first case,

which is known as an arm's length transfer, the Court may set aside the transfer only if the trustee can prove that it was made outside of normal business dealings in the trade or, to the knowledge of the creditor, outside of the normal business dealings of the debtor. In the case of a non-arm's length transfer, the burden of proof that the transaction was not a preference is normally on the creditor. The Bill deals specifically with preferences granted by a debtor to a person who had previously guaranteed his debts.

The Bill also empowers the Court to set aside a security interest of a creditor if the debtor was under no previous legal obligation to grant it. Even if there was such an obligation, the Court may set aside the security interest if it was not given, in the case of property already owned by the debtor when he contracted the debt, within 30 days of contracting the debt, and in the case of property acquired by the debtor subsequent to the debt, within 10 days of acquisition of the property. Where the court thus sets aside the security interest, the benefit of the avoidance ordinarily goes to the estate of the debtor and not, as under the present law, to some other creditor who had also a security interest in the same property but subordinate in rank.

In addition to the above provisions, the Bill deals specifically with the problems created when a debtor makes a lump sum payment of premium on an insurance policy, assigns accounts receivable due to him, or substitutes other property previously released or returned by a creditor.

As a general defence, the Bill provides that the Court may not set aside a transfer if the creditor proves that at any time after the transfer was made the debtor was solvent and able to pay his debts and was paying his debts generally as they became due. In any case, proceedings to avoid transfers caught by the code must be brought by the trustee within 5 years of the date of bankruptcy.

Leases of Real Property

To deal with a frequent and particularly intractable problem the Bill sets out a number of provisions to specify the respective rights, duties and powers of a lessor, lessee and the trustee where a lessee becomes bankrupt. In particular, the Bill makes clear the trustee's right to occupy the leased property and to retain or disclaim the lease and also the lessor's right to receive rent. In addition, the Bill contains provisions to clarify the rights of a sub-lessee and of a mortgagee of the leasehold.

PART VI — ARRANGEMENTS AND BANKRUPTCY

(Sections 224 – 307)

PRESENT LAW

Part V of the present Bankruptcy Act sets out the substantive rules that govern the most important aspects of estate administration, including rules relating to filing proofs of claim, staying of creditor proceedings, priorities among creditors and the resulting scheme of distribution, creditors and inspectors meetings, and the powers of boards of inspectors. These rules also apply, in most circumstances, to a proposal made by a debtor under Part III.

Claims Against an Estate

Any creditor, whether secured or unsecured, may file a claim with the trustee if his claim arose before the date of bankruptcy. Where a claim is merely contingent or is for an unliquidated amount, the trustee has to apply to the Court for directions. The Court may value the claim or, where damages have to be assessed, direct that the issue be tried.

The Act empowers the trustee to reject or reduce any claim that a creditor cannot prove, but he cannot reject or reduce it on the ground that the underlying transaction was harsh or unconscionable or that the cost of borrowing was excessive. In Provinces having legislation against

unconscionable transactions, the trustee must apply to the Court to rule on the validity of the claim under the applicable law.

Release of Debts

When a bankrupt obtains his discharge from the Court, he is released from all debts and liabilities except those within a small category, such as a fine or penalty, debts incurred fraudulently, family maintenance, and debts for necessaries. Despite this complete release from his debts, it is possible for a creditor to take advantage of the discharged debtor's financial plight and induce him to pay the released debt. Whether a promise to pay a released debt is valid is not clear under existing law, but if a creditor gives further credit to the debtor on condition that the debtor also repays the released debt, it appears that the obligation in effect revives, unless it can be repudiated as an unlawful penalty or unconscionable under provincial law.

Claims of Secured Creditors

When bankruptcy occurs, the present Act prohibits creditors from commencing or continuing any legal proceedings for the realization of their claim against the debtor, except with leave of the Court. Even though this restriction does not affect a secured creditor, the trustee may apply to the Court to delay the realization of security held by a secured creditor for a period of 6 months. The trustee may also call upon a secured creditor to value his security and file an affidavit of value within 30 days and may, at his option, redeem the security at its assessed value or require the property to be sold. The secured creditor may file a claim for any unsatisfied portion as an unsecured creditor. A secured creditor may surrender his security interest to the trustee and file a claim for the entire debt as an unsecured creditor.

Scheme of Distribution

Although not immediately clear from the text of the present Act, the law in fact divides creditors into four classes: secured, preferred, ordinary unsecured, and deferred creditors. Except as mentioned above, the secured creditor remains essentially outside of the statutory scheme of distribution, free to exercise his rights against the debtor's property unless the trustee intervenes. And even then the secured creditor has absolute priority to the extent of his security interest. Preferred creditors are creditors to whom Parliament has given special priority to ensure the administration of the estate or to achieve greater equity among claimants. These preferred claims include funeral expenses, costs of administration, the Superintendent's levy, arrears of wages, arrears of municipal taxes, three months rent arrears, U.I.C. and Workmen's Compensation withholdings and so on. After these preferred claims are paid in full, the ordinary unsecured creditors share any balance rateably. If, after unsecured creditors are paid, a further balance remains it is paid rateably to the deferred creditors. Any remaining surplus is paid to the debtor. All creditors in a specific category are paid rateably. But the order of priority is strict: no payment is made to a lower priority creditor until all higher priority creditors are paid in full.

Meetings of Creditors

The present Act requires the trustee to call the first meeting of creditors of an estate within 5 days of his appointment and hold it within 15 days after the notices have been mailed. It sets out the procedure at meetings, including quorum, voting and proxies. The purpose of the meeting is to inform the creditors of the financial affairs of the bankrupt, to appoint inspectors, to affirm the trustee's appointment or to substitute another trustee, and to obtain directions from the creditors. A recurring problem in recent years has been the difficulty in obtaining a quorum at the first meeting in almost all but large estates. This is especially true of summary administration cases (individual bankrupt having less than $500.00 assets after deducting secured creditors claims). As a result, the administration of an estate during the first, and often critical, weeks is

delayed and the checks on the powers of the trustee that the meeting is designed to provide are generally ineffective.

PROPOSED LAW

Part VI of the Bill introduces a number of significant changes to the present law. It applies to commercial arrangements under Part IV, to all bankruptcies, and in part to consumer debtor arrangements.

Claims Against the Estate

The Bill empowers the trustee summarily to set aside or reduce any claim, priority or security interest on property on the ground, among others, that the underlying transaction was harsh or unconscionable or that the cost of borrowing was excessive. His decision may be appealed to the Court. The Bill also requires the trustee to value contingent and unliquidated claims filed with him. Again, his valuation may be appealed to the Court.

Release of Debts

A bankruptcy order has the effect of releasing the debtor from all debts and liabilities except (a) a fine or penalty imposed by a Court, (b) a debt arising out of a recognizance or bail bond and (c) a liability to maintain a spouse or child for a period subsequent to an arrangement or bankruptcy. A debt thus released cannot be revived by agreement even if the creditor furnishes new consideration.

Claims of Secured Creditors

Modifying substantially the policies of the present Act, the Bill requires a secured creditor always to file a proof of security interest with the trustee. "Security interest" is defined to include any interest that is in fact security for repayment of a loan, irrespective of the legal device used. The secured creditor is prohibited from dealing with the estate property in which he has a security interest until after he has filed his proof and the trustee has failed to redeem the property within the stipulated time period (usually 30 days). Moreover, the Bill subordinates the claims of secured creditors to any claims for arrears of wages, which are deemed to be claims for secured debts that have priority over any other security interest.

Protection of Wage Earners

This grant of priority to wage claimants over all other creditors is limited to arrears of wages, including arrears of severance pay and holiday pay up to a maximum of $2,000 for each employee. If the funds or unencumbered assets available in an estate are insufficient to meet this liability, the security interest held by secured creditors will be scaled down rateably. Instead of enforcing the security by sale, assessment of a levy, or other means, the trustee may borrow money to pay the wage claim and grant to the lender of that money a security interest having the same priority that the Bill gives to wage claimants. The secured creditors are, however, subrogated to the claims the wage earners have against the directors of the bankrupt corporation, who are personally liable for arrears of wages up to $2,000 per employee in case of bankruptcy, and are also entitled to rank along with wage earners for the balance of their wage claims as preferred creditors.

Further to protect wage earners and their dependents, the Bill makes it unlawful for an employer to dismiss an employee by reason only that he is subject to proceedings under the Bankruptcy Act. It also declares void a wage assignment obtained by a creditor as security for a debt, as from the date of the bankruptcy order.

Scheme of Distribution

In addition to modifying the absolute priority that secured creditors have under present law, the Bill sets out an order of priority that reduces considerably the classes of preferred creditors (certain administrative costs, wage arrears, lessor's claim for three months arrears of rent, and Crown claims for moneys deemed held in

trust up to a maximum of the cash on hand or on deposit), clarifies the position of ordinary unsecured creditors, and particularizes the rights of deferred creditors. Although long, the order of priorities provisions of the Bill, which are necessarily the nucleus of a bankruptcy law, attempt to clear up what is an unnecessarily archaic and complicated area of the law.

Meetings of Creditors

Although it varies time periods slightly, the Bill essentially continues the basic policies of the present law: the trustee is required to call the first meeting of creditors, which must be held within 20 days of the date of the bankruptcy order; and the trustee may call any subsequent meeting of creditors and is required to do so when directed by the Court, the board of inspectors, or a specified number of creditors.

One of the policies of the Bill is to encourage creditors to participate more actively in estate administration, therefore the Bill sets out a fairly detailed code of procedures to govern meetings of creditors, the election of inspectors, and the rights and duties of inspectors. To make possible improved representation for minority creditors the Bill permits a creditor to cumulate his votes and cast all of them for one inspector.

Because creditors have little interest in estates with few assets, they frequently neglect to attend meetings, even to elect a board of inspectors. The Bill therefore empowers the Superintendent to appoint inspectors where the creditors fail to do so and to appoint an inspector where the Crown is a creditor. The Bill also empowers the Superintendent to appoint a supervisor to maintain continuous surveillance over an estate that is especially complicated or troublesome.

PART VII — STOCKBROKERS

(Sections 308 – 318)

PRESENT LAW

The present Bankruptcy Act contains no special provisions concerning the bankruptcy of stockbroker firms, notwithstanding that such bankruptcies have proved to be especially complicated and problematical.

These bankruptcies are inherently complicated because the stockbroker's business is complicated. He trades securities in large volume on volatile markets on his own behalf and for customers. He pledges his own or customers' securities with banks to secure operating loans and purchase money loans for his customers. He holds securities in various ways for customers. Many are in the name of the broker or another broker and endorsed ("street form"). Some are in the customer's name but endorsed so that the broker may trade at his discretion or for the customer's convenience. Some are in the customer's name and endorsed, but segregated and identified as belonging to the named customer. Some are in the customer's name and both unendorsed and segregated. Complicating matters further, the broker frequently holds free cash balances for customers that arise from securities sales.

Frequently, when a broker gets into serious financial difficulty he fails to comply with either the regulations or his customer's instructions, and as a result the rights of creditors and customers to specific securities and to free cash balances become completely confused. Under the present law, when a bankruptcy occurs, the trustee is required to unravel what is usually a tangled mess in order to identify and distinguish between ownership rights in specific property and mere creditors' claims. To do this he must apply complicated common law rules concerning the identity of the owner of a security and even more complicated equitable tracing rules based on the idea that a broker holds securities, if fully paid, in trust for his customer, entitling a customer to recover that quantity of securities even where he cannot be specifically identified as owner of the securities. In the final result a particular customer's priority usually is determined as a matter of pure chance, depending on the degree of broker misconduct, the form of the

security, its status on the corporate securities register, the manner in which the broker segregated or identified it, or the way the broker dealt with it (e.g., permitting recovery of a gift or a preference).

PROPOSED LAW

In its Report, the Bankruptcy Study Committee recommended that the proposed Bankruptcy Bill contain a separate part dealing with stockbrokers' bankruptcies, following generally the model set out in the current United States Bankruptcy Act.

Further study by the policy analysts revealed that although the U.S. statutory model is more refined than the present Canadian common law, it is not clear that it is either fairer or more efficient. In order to establish priority among claimants, the U.S. statute continues to distinguish among the nature of the customer's claim against the broker (dividends received for the customer, cash received in connection with securities trades, securities held for a customer), the manner in which a broker keeps his customer accounts (cash or securities clearly allocated to a customer, securities kept in segregated bulk, securities clearly earmarked as a customer's property, etc.), and the form of the securities certificate (in a broker's name — "street form", in a customer's name and endorsed, in a customer's name and not endorsed, etc.). While clearer than the common law, this particular statutory model leads to a myriad of legal complications and, consequently, to great administrative delays and demonstrable inequities among customers and other creditors of a stockbroker.

The analysts, therefore, considered a wide range of possible models.

- Ordinary commercial bankruptcy, subject to identification and tracing rules, that is, the present common law.
- Customer preference over trade creditors but no limit on the securities identification and tracing rules.
- Customer's preference over trade creditors with constraints on the identification and tracing rules, limiting those remedies to the recovery of money or securities a claimant can "... specifically identify as allocated to a customer", which is in essence the U.S. model.
- Customer preference over trade creditors to the extent of cash and securities held by the stockbroker, and customers and trade creditors sharing the other assets rateably.
- No customer preference and, instead, all assets placed in a common fund that customers and trade creditors share rateably.

From an administrative point of view, the last model is the most attractive, but when a bankrupt stockbroker has substantial trade creditors it could be grossly unfair to customers. The penultimate model was therefore recommended, subject to the further qualification that the law distinguish between arm's length customers and non-arm's length associates and affiliates (related customers) and persons who caused or contributed materially to the bankruptcy of the stockbroker (deferred customers), relegating the related customers to a second priority claim in all cases and the deferred customers to a lower rank.

The advantages of this model are that it enormously simplifies the legal conflicts, expedites administration, distinguishes between "good" and "bad" customers to determine priorities, and so permits a fairer settlement of claims.

In brief summary, the proposed model operates as follows. A stock exchange or securities commission as well as a creditor is empowered to initiate bankruptcy proceedings and must, in any event, receive notice of any third party petition. The general rules concerning the vesting of all debtors assets in the trustee, the broad powers of the trustee to continue the business, and the fraudulent preference rules apply to stockbroker bankruptcies. In addition, the trustee is empowered to elect, within 20 days of the bankruptcy, to satisfy all or part of any claim of a customer against the estate in respect of securities by

delivering out to the customer securities of the same class and kind to which he was entitled at the date of bankruptcy, irrespective of any change in value in the securities after that date. In short, during those 20 days, the customer bears the full risk of ownership of those securities. After settling, where feasible, any claims by the delivery out of securities, the trustee is required to divide all assets of the stockbroker into two funds: the first consisting of all cash and securities and the second consisting of all other assets of the stockbroker. In the course of processing proofs of claim against the estate, in order to distinguish which creditors have claims against either fund, the trustee must distinguish between arm's length customers, and related customers, that is, those customers who are associates or affiliates of the stockbroker and the deferred customers, that is, those customers who caused or materially contributed to the bankruptcy of the stockbroker. As to the first fund, the arm's length customers have first priority and the related customers have second priority. As to the second fund, if customer claims remain outstanding, the arm's length customers and trade creditors have a rateable first priority and the related customers second priority. Deferred customers rights are postponed until all other customers and trade creditors are paid in full.

Although not mentioned in the Bill, this part presumes that the appropriate stock exchange and securities commission will cooperate fully with the trustee in bankruptcy to enable him to administer a stockbroker's estate in this manner, and also that the securities industry contingency fund will continue to be available to ensure an arm's length customer, if not in full, at least in large part from loss in the event of a stockbroker's bankruptcy. Indeed, it is probable in a typical case that the stock exchange or securities commission will initiate bankruptcy proceedings, the contingency fund will move at once to satisfy arm's length customers claims, and then the contingency fund, being subrogated to the claims of those customers, will press the trustee for recovery from the estate, thus ensuring expert intervention to make claims and also expert surveillance of estate administration.

PART VIII — INSURANCE COMPANIES

(Sections 319 – 341)

PRESENT LAW

The present Bankruptcy Act does not apply to insurance companies. An insolvent insurance company may be wound-up only under the Winding-Up Act, which applies to insurance companies that are incorporated or carry on business in Canada.

The common insolvency tests — excess of liabilities over assets or inability to pay debts as they become due — do not apply to determine whether an insurance company is insolvent. Instead, specific rules set out in the Winding-Up Act deem an insurance company to be insolvent if it fails to pay a claim for which it is clearly liable within 90 days, if the Superintendent of Insurance refuses to renew its registration because the company is not in a position to meet its liabilities, or if its registration is withdrawn under an act that deems such withdrawal to constitute insolvency.

Where an insurance company is insolvent, the company itself, a creditor, or the Attorney General of Canada upon the request of the Minister of Finance may apply to the Court for an order to wind up the company.

Upon making the liquidation order the Court may appoint one or more liquidators — who may be but are not required to be licensed trustees in bankruptcy — to administer the liquidation. Under the general scheme of the Winding-Up Act, however, the liquidator's functions are largely formal, since the Court is required to approve in advance almost every administrative act. The creditors have no role in the liquidation other than to express their views when so requested by the Court. The inspectors, too, are appointed by the Court; their function is to

advise the liquidator rather than to represent the creditors' interests. The Superintendent of Insurance, although he may initiate the winding-up by refusing to renew registration of an insurance company, has little or no power to control the liquidation.

Reflecting the special character of the insurance business, the Winding-Up Act empowers the liquidator to reinsure policies issued by the company instead of returning unearned premiums to the policy holders, in effect transferring the insurance coverage to another insurer. Otherwise the liquidation of an insurer is presumed to be comparable to that of any business corporation. The liquidator gathers in and liquidates the assets, identifies the claimants and qualifies their claims, and distributes the assets to the claimants in accordance with the following order of priority set out in the Winding-Up Act: (1) liquidation costs; (2) wage earner claims for 3 months arrears of wages; (3) claims under policies and unearned premiums; and (4) claims of other creditors.

The present law applicable to the winding-up of insurance companies is defective in several respects. Administration is excessively legalistic, resulting in unnecessary costs and delays. The administrative system largely ignores the strategic role of the appropriate superintendent of insurance as regulator of the insurance industry. And finally, the substantive rules relating to what constitutes insolvency, the distinctions between different kinds of insurance, and the treatment of persons holding life policies as distinct from health and accident, liability, and property policies, are demonstrably inadequate.

PROPOSED LAW

The principal policy goals of the Bill are to bring insurance company bankruptcies as far as possible into the mainstream of bankruptcy law, to involve the appropriate superintendent of insurance directly in the insolvency process, to streamline administrative procedures, and to clarify a number of substantive issues that are ambiguous in or absent from the present law.

Under the Bill, much as under the present law, the Attorney General of Canada or of a province on his own initiative or upon the request of the Minister responsible for the law applicable to insurance companies, the company itself, or a creditor may initiate bankruptcy proceedings. In addition to the general insolvency tests of the Bill — excess of liabilities over assets or cessation to pay debts generally as they become due — there are a number of specific tests that apply to insurance companies, relating generally to the non-renewal or cancellation of the insurer's licence and, in the case of a foreign company, failure to maintain sufficient assets in Canada.

The major changes effected by the Bill concern administration. As in any other bankruptcy, the trustee is required to be a licensed trustee (each superintendent of insurance is deemed to be a licensed trustee) and the creditors maintain policy control over the liquidation through inspectors they appoint. In addition, however, specific rules empower the appropriate superintendent of insurance to attempt a rescue operation. A petition for a bankruptcy order affecting an insurer must be served on the superintendent before being filed in Court. Although the Bill prohibits an arrangement in respect of an insurance company, the bankruptcy proceedings are automatically suspended for 60 days (unless the superintendent consents to a shorter delay) to give the superintendent time to determine whether the company has enough assets to enable it to reinsure its outstanding policies with other insurers or, alternatively, whether some other company will amalgamate with or buy the business of the insolvent company. Reinforcing this policy, the Bill provides that policies issued by the insolvent company subsist 45 days after the date of the bankruptcy in order to give each insured adequate time to seek coverage elsewhere. Moreover, during this period of time reinsurance policies issued in favour of the insolvent company are deemed to subsist. For

any premium deficiency the reinsurer ranks as an ordinary creditor. In sum, great emphasis is placed on protecting the insured, part of the cost of which is borne by the insurance industry as a whole.

If rescue attempts prove unsuccessful, the bankruptcy order is made as in any other case. Unless he declines appointment, the appropriate superintendent of insurance automatically becomes trustee. If he declines, a licensed trustee is appointed and confirmed by the creditors, and the superintendent of insurance maintains surveillance by becoming automatically a member of the board of inspectors.

The general administration rules of the Bill apply to insurance company bankruptcies. Special substantive rules are added, however, to distinguish between holders of life policies and holders of non-life policies, particularly to make possible special orders of priority relating to life insurance (or life and other classes of insurance) on the one hand and other classes of insurance business on the other and to integrate these with the general priority rules of the Act. More particularly, the Bill provides for distribution in accordance with the following orders of priority:

(1) Life insurance (or mixed life and other insurance) companies.
   (a) Costs of administration.
   (b) Payable rateably, the net amount payable to beneficiaries because of the death of the insured, the value of the policy where no claim has been made, and the proceeds of agreements to settle claims deposited with the company.
   (c) Claims of other creditors in accordance with the usual bankruptcy rules.

(2) Non-life insurance companies.
   (a) Costs of administration.
   (b) Third party claims under liability policies.
   (c) Claims under a policy other than third party claims.
   (d) Claims for the value of subsisting policies.
   (e) Claims of other creditors in accordance with the usual bankruptcy rules.
   (f) Expenses of the Federal Superintendent of Insurance.

Although more detailed and seemingly more complicated than the rules that apply to insolvent insurance companies under existing law, Part VIII, recognizing the special nature of the insurance business, sets out a system that is fairer to third party claimants and policy holders, better integrated with the regulatory scheme, and certainly easier to administer.

PART IX — RECEIVERSHIPS

(Sections 342 – 346)

PRESENT LAW

The appointment of a sequestrator or receiver is an ancient legal institution designed to empower a creditor, acting through the receiver as an independent third party, to take possession of the debtor's property in which the creditor has a security interest with a view to preserving the property, collecting rents, or even liquidating the property to realize his claim. In all jurisdictions in Canada a receiver may be appointed either by the Court, in which case he is an officer of the Court, or by the creditor in accordance with the express terms of a mortgage or trust indenture, in which case he is generally agreed to be an agent of the debtor and not of the creditor.

A receiver may be appointed by a Court or extra-judicially by a creditor because the debtor is in default in respect of one of a great many possible conditions stipulated in the agreement creating the security interest; e.g., failure to insure, failure to pay property taxes, improper sale of inventory covered by a floating charge, improper assignment of accounts receivable, improper conversion of the proceeds arising from the sale of secured assets, and so on. More frequently however, a receiver is appointed

because the debtor is insolvent or becomes bankrupt.

Under the present Bankruptcy Act, because the bankruptcy administration is generally subject to the prior rights of secured creditors, a receiver may be appointed before or after the date of bankruptcy to take possession of all the assets of the estate, leaving few if any assets to be administered by a trustee in bankruptcy. This is particularly true where the creditor has a very comprehensive security interest under a trust indenture. Such a security interest can include a specific charge on identifiable assets, both present and future acquired, and also a floating charge on revolving assets, such as inventories and accounts receivable, which floating charge crystallizes as a fixed charge at the moment of bankruptcy or even before bankruptcy upon the appointment of a receiver.

That is not to say, however, that a trustee in bankruptcy should always be involved, for frequently the assets can be realized more effectively by a receiver. Under present law, however, there is no mechanism to permit either the unsecured creditors or the Superintendent of Bankruptcy to maintain any surveillance over the receiver's conduct to ensure that the receiver acts fairly, keeping in mind the residual claims of all subordinate creditors.

PROPOSED LAW

Recognizing that the appointment of a receiver is an effective remedy to protect legitimate creditor interests, the Bill does not attempt to displace receivers in all cases where a bankruptcy occurs. But the Court may, upon the application of an interested person, impose additional duties upon the receiver or terminate the appointment of the receiver and appoint another person in his place where it appears that there might be a surplus left after the secured creditor realizes his security, unless the receiver proves to the satisfaction of the Court that a surplus is improbable.

Instead of setting out rules to govern the conduct of a receiver in case of bankruptcy, the Bill empowers the Court, where it decides to intervene, to give directions to the receiver or his successor with respect to all dealings with the debtor's property. And in any case the receiver is required, upon demand, to furnish specified information about the receivership to the Bankruptcy Administrator or the trustee in bankruptcy. In sum, these procedures ensure, on an exceptions basis, that the interested parties will have the right to know on what authority a receiver acts and what he is doing and to apply to have the Court intervene where it appears there might be a surplus available for distribution among the subordinate secured creditors, the persons having claims against the debtor's estate, and the debtor.

Although not set out in Part IX, the Bill imposes one further constraint on a receiver. Where there is no bankruptcy because the receiver has possession of all the debtor's assets, if wage earners have claims for wage arrears (which take priority even over the rights of secured creditors), and if the receiver fails to pay those claims, the wage earners may petition the debtor into bankruptcy, have a trustee appointed, and so enforce their priority under the Bill. In case the wage earners cannot retain a private trustee, they may request that a public servant trustee be appointed to resolve the issue.

PART X — OFFENCES

(Sections 347 – 372)

PRESENT LAW

The principal purposes of the penal provisions set out in the present Bankruptcy Act are to promote commercial honesty and to ensure that the estate of a bankrupt is lawfully administered. These offences complement the offences set out in the Criminal Code and can be invoked as a basis for prosecution only after a bankruptcy actually occurs, but some provisions reach back

to cover offences — e.g., fraudulent transfer or receiving of property — that occurred before the date of bankruptcy.

In general, these penal provisions promote commercial morality by making it an offence for a debtor alone or acting in concert with one or more of his creditors to conceal or misappropriate property that should have fallen into the debtor's estate. And these penal provisions ensure honest administration by making it an offence for any unqualified person to act as trustee, for a creditor to make a false claim, for an inspector to accept an unlawful fee, or for a trustee to commit a breach of specified statutory duties.

The various offences set out in the present Act, depending upon their relative seriousness, are punishable on indictment or on summary conviction. Prosecution of an indictable offence must be commenced within 5 years and prosecution of a summary conviction offence must be commenced within 3 years of the commission of the offence. In most cases the applicable penalty is mandatory imprisonment.

The 1966 amendments to the present Act increased considerably the Superintendent's powers to undertake or to direct the detection and investigation of suspected bankruptcy offences, enabling him to initiate investigations instead of simply urging the appropriate provincial Attorney General to act. Also in 1966 the Superintendent established detection and investigation divisions in regional offices across Canada, staffed by auditors and trained investigators who are better able to detect and investigate local cases. Contemporaneously, the R.C.M.P. established special bankruptcy squads in major centres to assist the Superintendent in his investigations.

In sum, therefore, a person suspected of a bankruptcy offence may be investigated and charged under the Bankruptcy Act, and, if the misconduct is also a crime, may also be investigated and charged under the Criminal Code.

PROPOSED LAW

The proposed law essentially continues the substantive offences and the investigative procedures of the present Act. The Bill does, however, add several modifications: its scope is extended to include arrangements as well as bankruptcies; it authorizes an investigation to begin at once upon the commencement of proceedings under the Bill; it removes the time limit on prosecuting indictable offences and reduces the time limit on summary conviction offences to 2 years; it extends the bribery rules to include all persons involved in a bankruptcy administration — a Bankruptcy Administrator, trustee, inspector, solicitor or auctioneer; and it adds a new offence concerning the failure of a director of a corporation who becomes bankrupt to resign as director. The Bill also introduces new sentencing provisions, giving the Court greater discretion to impose a fine instead of imprisonment or to impose a fine and imprisonment, rather than impose mandatory imprisonment, which is now the general rule.

PART XI — COURTS AND EVIDENCE

(Sections 373 – 399)

PRESENT LAW

The present Bankruptcy Act, in contrast to the pre-1949 statute, does not create a separate bankruptcy court. Instead, in line with the general policy of Parliament not to establish a duality of Courts, it vests original jurisdiction with respect to bankruptcy matters in the Superior Court of each province. Generally, however, the Chief Justice of the province specifically assigns one or more judges to exercise judicial powers conferred by the Act and appoints or designates the registrar, clerks and other officers to transact the business of the court. Proceedings before the court are instituted in accordance with the General Rules enacted pursuant to the Act, or, in cases where the Act or the Rules make no provision, the ordinary rules of procedure of the Court in civil matters apply. In addition, in respect of bankruptcy matters, the

Act requires the court to have a seal, makes each court auxiliary to each other court and makes orders of one court enforceable by another court anywhere in Canada. As a result a superior court exercising judicial powers under the Bankruptcy Act tends to become identified as a separate court.

In practice this confusion about the exact status of the court frequently makes it difficult to determine what is the proper forum to decide issues that are not within the scope of the Bankruptcy Act but that directly concern the bankrupt and his estate; e.g., the respective rights of claimants that have registered mechanics liens against property of the bankrupt. Some of these proceedings can, under provincial law, be brought only in courts of inferior jurisdiction such as the Small Claims Courts and County Courts, the Superior Court having only appellate jurisdiction.

The Act also vests many areas of control and authority in the Court, such as the discharge of trustees or the taxation of accounts. These are administrative responsibilities which should properly be handled by the bankruptcy officials to ensure the application of uniform policy across the country.

PROPOSED LAW

Part XI of the Bill proposes to continue the basic structure and authority of the court; but it provides for the transfer to the court of any proceedings taken in any court if they affect the rights and interests of a bankrupt or his estate with a view to eliminating jurisdictional conflicts.

The Bill modifies substantially the court's functions, relieving it of a number of essentially administrative functions such as reviewing and approving the estate accounts submitted by trustees and discharging bankrupts. Under the Bill estate accounts would be passed by the Bankruptcy Administrator, subject to appeal to the court. Legal fees resulting from court proceedings would, however, still continue to be taxed by the courts. And instead of discharge of a bankrupt by court order, the bankrupt is automatically discharged 90 days after the date of the bankruptcy order unless the Bankruptcy Administrator files a caveat within those 90 days to block the discharge, shifting the onus to the debtor to apply to the court to have the caveat removed. Thus the court hears discharge applications only in exceptional cases.

Two important innovations are included in this Part of the Bill. Firstly, wherever the words "upon application" are used throughout the Bill, these words should, according to subsection 377(1), be interpreted as granting to any interested person the right to apply to the Court, unless the Bill otherwise states expressly who may apply. Secondly, the Court is granted the power to shorten or extend the period of time during which a proceeding must be taken or an act or thing done under the Bill, either before or after the expiration of the limited time period.

Part XI of the Bill also deals with rules of evidence in bankruptcy proceedings. It includes provisions clarifying in what circumstances and under what conditions a document made in the course of a proceeding or the evidence of any person examined pursuant to the Act is admissible. The Bill also simplifies the rules applicable where property of a debtor is seized and held as evidence of an offence under the Bankruptcy Act or the Criminal Code by providing that a sample or proper description of the seized property would be receivable in evidence in the prosecution of the offence without the necessity of retaining under seizure or producing at the trial the seized property in its entirety, as is presently the case.

PART XII — GENERAL AND TRANSITIONAL

(Sections 400 – 410)

PRESENT LAW

The four statutes proposed to be abrogated

by the Bill — Bankruptcy Act, Winding-Up Act, Companies' Creditors Arrangement Act, Farmers' Creditors Arrangement Act — contain a number of miscellaneous provisions of general application and also relatively broad rule making powers to prescribe regulations governing administration, court practice and procedure, and tariffs of fees.

PROPOSED LAW

The Bill, in Part XII, attempts to consolidate these general rules in one Part. These general rules are designed to resolve on a Canada-wide basis specific problems that recur frequently: e.g., rules concerning the estate of a deceased bankrupt, the continuance of a statutory limitation or prescription period while a proceeding is stayed under the Bill, and the status of a married woman.

This Part also consolidates all the pertinent regulation making powers which under the present Winding-Up Act are vested in the courts and under the Bankruptcy Act are vested in the Governor-in-Council but supplemented by rules of court. Under the Bill all regulation making powers vest in the Governor-in-Council. These include power to make regulations required to be prescribed (e.g., the maximum of exempt property that does not fall into a bankrupt's estate, administration forms, etc), to prescribe the form and time of notices, and to establish fees for specific services and the amount the Superintendent may levy against each estate to recover his administrative costs.

Consistent with the overall concern of the Bill to adhere to exacting administrative law standards — for example, administration by exception to minimize unnecessary paper work, express licensing criteria to guide judicial review of licensing decisions, express right of appeal to a court in respect of the taxation of accounts, and judicial control over many investigative powers — the Bill subjects the regulation making powers exercised under it to close public scrutiny, particularly by requiring pre-publication of proposed rules and forms.

The Bill sets out a number of transitional provisions to make clear that existing proceedings will continue under the former law, and also to ensure that a cross reference in the statutes or corporate constitutions to a predecessor Act such as the Winding-Up Act is deemed to be a reference to the new Act. Finally the Bill provides that, unless the court has issued a conditional discharge, all individuals who became bankrupt under the present Act are automatically released of their debts within five years from the date of their bankruptcy.