Supplying Goods And Services To An Insolvent Company:

Practical Advice For Clients On How To Get Paid
or
Answering the Questions You Were Afraid Your Client Would Ask About Insolvency

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INTRODUCTION

Insolvency law is confusing. This is true for not only general practitioners but, particularly, for clients who may become unwillingly involved in an insolvency due to an unfortunate credit decision or who may wish to supply an insolvent company. In addition, time truly is of the essence in insolvency matters. As judges on the Commercial List have noted, insolvencies "happen in real time". This paper will help you answer your clients' insolvency questions in a quick and effective manner.

Insolvency proceedings may be broken down into two categories; "formal", meaning, for the purposes of this paper, a process governed by a Court proceeding and "informal", meaning the exercise of private contractual remedies. Insolvency terminology overlaps and is confusing, even to lawyers who do not have expertise or experience in this field. Accordingly, clients who realize they are being asked to supply or have supplied goods to an insolvent customer will need professional assistance so that they may properly assess the risks they are undertaking.

The purpose of this paper is to provide the practitioner with a quick and practical reference guide to the issues that arise for client/suppliers in various types of formal and informal insolvency proceedings in two critical regards, namely:

A. supplying future goods and services; and

B. recovering outstanding claims.

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A. SUPPLYING FUTURE GOODS & SERVICES
or
"DO I CONTINUE TO SUPPLY WHEN …"

This section will consider the implications of continuing to provide goods or services in various insolvency scenarios, including a Court-appointed receivership, a private receivership, a "soft", "quasi" or near receivership, a *Companies' Creditors Arrangement Act* (Canada) ("CCAA") proceeding and a *Bankruptcy and Insolvency Act* (Canada) (the "BIA") proposal.

Tip No. 1: Identify the nature of the proceeding and the status of the participants.

Insolvency law suffers from a lack of descriptive terms. Vastly different considerations arise in circumstances where identical terminology is used. For example, it is not enough to know that a "receiver" has been appointed or that a "trustee" under the BIA is involved. You must ascertain whether the "receiver" is privately appointed or Court appointed and whether the "trustee" is a trustee in bankruptcy or a trustee under a BIA proposal. This problem is exacerbated by the loose use of common terms, even among practitioners. A client may tell you that a customer is in receivership, bankruptcy or insolvency, but the facts may be that the customer is in one of those conditions or all three. The key to understanding your client's position will be in understanding the exact status of the customer.

Tip No. 2: Ask the Pro. Obtain from your client the contact person of the insolvency professional whose status is in question and call that person to get the most up to date facts.

Insolvency proceedings, both formal and informal, often evolve rapidly. Only by knowing the most current factual situation will you be able to give the best advice. Armed with these facts, you will then be free to determine under which of the following scenarios the customer's situation falls.

1. Court-Appointed Receivership

If you are advised that your client's customer is in receivership, first ascertain from the receiver

the nature of the appointment. Court-appointed receivers (or receivers and managers) and their counsel usually have an ample supply of appointment orders, and you should obtain a copy of this as soon as possible. Although you may also wish to obtain a copy of the notice which will usually be required under s. 245 of the BIA, the far more important source document is the receivership order itself, from which all of the receiver's powers flow.

A Court-appointed receiver has a duty to all creditors. This should be of comfort to your client since the person in direct control of the proceeding will not be obeying any particular creditor's agenda. Furthermore, the Court-supervised process ensures that there are mechanisms by which any grievances can be addressed which include:

(a) bringing a motion in the receivership proceedings, often by recourse to the "come-back" clause which is standard in most receivership orders; and

(b) the opportunity to appear at hearings which will be scheduled periodically to approve the receiver's conduct or when the receiver appears to pass its accounts.

Most importantly, from the point of view of supplying a Court-appointed receiver, the supplier/client will be comforted by the fact that, in the vast majority of cases, the receiver will be granted a first priority charge over all of the assets of the debtor to secure its fees and disbursements, which fees and disbursements will include payments for goods and services supplied. Furthermore, a receiver who is given a mandate to continue the business of the debtors, usually referred to formally as a receiver and manager, will be given a borrowing power against the security of receiver's certificates to allow the receiver to have funds to pay for ongoing supplies. In both of these cases, the client/supplier need only satisfy itself that there are sufficient assets over which the receiver has jurisdiction to justify the provision of ongoing supplies, even on credit. You should also confirm that all significant secured creditors registered under the *Personal Property Security Act* (Ontario) and against title to affected real properties are parties to the proceeding, which is usually the case.

However, in the ordinary course, especially in the initial stages of a receivership, receivers expect and suppliers will insist, that all supplies be on a "cash on delivery" (COD) basis. In cases where a receiver-

ship continues for significant periods of time and where the receiver has significant borrowing powers as established by the appointment order, it is not unusual for receivers to request credit terms. In these cases, such credit terms are justifiable provided that:

(a) the receiver has the power under its order to request credit terms; and

(b) the total credit sought by the receiver, including borrowings under receiver certificates, are less than the net realizable value of the assets in the receivership.

In most receiverships, the combined borrowing power of the receiver, whether by way of receiver's certificates or for goods and services supplied on credit is far less than the value of the assets being administered.

Tip No. 3: Check the Court order as a source document to confirm the receiver's priority for its receipts and disbursements. Invoice in the name of the receiver "acting in its capacity as receiver under the Court order" to enjoy the benefit of that priority.

From an administrative view, your customer should be advised to supply the goods or services to the name of the insolvency professional "in its capacity as receiver (or receiver and manager, as will usually be the case) pursuant to Court order dated _____" and not to the debtor nor simply to the name of the limited liability company of the insolvency professional acting as the receiver. A Court-appointed receiver is a separate entity from the original debtor and the estate is a separate entity from the corporate entity acting as the receiver. It is only the insolvency professional acting in its capacity as the receiver under the Court order which enjoys the first charge over the assets. It is from this Court-ordered priority charge that a supplier will take comfort in supplying a Court-appointed receiver and the paper trail should be made to match.

2. Private Receivership

Although also called a “receiver” or a “receiver and manager”, a privately appointed receiver bears little resemblance to a Court-appointed receiver insofar as a supplier is concerned. Such a receiver is merely acting on an appointment from a secured creditor and is acting primarily in that creditor’s interest subject only for a duty to act honestly, in good faith and in a commercially reasonable manner as required by s. 247 of the BIA and the common law. The private receiver is not a separate entity from the original debtor and, in fact, while carrying on the business of the debtor, is usually deemed to be acting as the agent of the debtor and not as the agent of the secured party in accordance with the terms of the security agreement under which the appointment is made. Therefore, if a supplier continues to supply goods or services on credit, it is at the same or higher risk it had in supplying the insolvent debtor in the first place.

It was to address concerns of suppliers in this regard that the amendments made to the BIA in 1992 required receivers of insolvent persons, as defined in s. 244 of the BIA, to deliver notices to all known creditors of the fact of the appointment. Section 245 of the BIA requires notice to all creditors within 10 days of the appointment. Prior to the enactment of this section, a privately appointed receiver was under no positive obligation to inform anyone but the debtor of the fact of the appointment and suppliers were left to their wits and rumours in the marketplace to determine whether a private receivership had occurred. To determine the nature of the receivership (See Tip No. 2 above), you should contact senior management of the customer and ask to speak to the insolvency professional in charge. Again, seek out the source document which, in this case, will be an appointment under an instrument, usually a security agreement.

Tip No. 4: For private receivers, it's COD all the way!

Although the receiver itself will often have an indemnity from the appointing secured creditor, this is of no comfort to the client/supplier. In the writers' experience, it is unusual for a private receivers to ask for, or to obtain, credit from unsecured suppliers. Instead, COD terms are the expected norm.

Unlike Court-appointed receivers which can be clothed with many powers pursuant to the appointment order, a private receiver merely "steps into the shoes" of the debtor and does not enjoy any stay of proceedings or protection from the termination of contracts against it. Therefore, in certain cases where a supplier is fortunate enough to be the sole source of a critical good or service necessary for a debtor to continue in operation, such supplier may demand extraordinary terms for continued supply, such as above fair market prices or even payment on account of outstanding unsecured invoices. A Court-appointed receiver would ordinarily resist any such attempts by a supplier and would seek an order of the Court in the receivership proceeding to compel continued supply on fair market cash-on-delivery terms. A supplier is usually hard pressed to successfully resist such a motion. The authority for making an order to compel supply in these circumstances lies within s. 101 of the *Courts of Justice Act* (Ontario) which empowers the Court to make whatever order is "just or convenient".

3. Soft Receivers: Consultants, Monitors, Agents and "Look-See" Reports

Often, a secured creditor will wish to have a better understanding of a debtor's business and the lender's security position before it decides upon a course of action to either restructure a loan facility or to initiate enforcement proceedings. Debtors will often cooperate with this process to avoid the ramifications of a demand and to stave off any such enforcement proceedings. During this period, your client may discover that its customer is being visited by a consultant, monitor or agent. Your problem, as a practitioner, will be in obtaining appropriate information to enable you to advise your client in these circumstances since the engagement of any such professional, often called, inappropriately, a "soft" receiver, is strictly confidential for precisely the reason your client will wish to know of its existence. In short, if the credit granting trade suppliers come to know that a secured creditor is considering its enforcement options, trade credit will evaporate with the effect of accelerating an already tenuous situation. The situation is further complicated by the fact that a company may hire a consultant for a number of reasons,

many of which have nothing to do with insolvency proceedings. Your job will be to guide your client in determining what manner of consultant is engaged.

Tip No. 5: Ask direct and blunt questions. Specifically, ask if the consultant has a mandate or requirement to report to any creditor. Be forewarned if the answers from either the company, its counsel or the consultant are refused or qualified.

When a consultant to a secured creditor is involved, your client is at risk and should seriously consider placing its customer on a COD basis and insist on the payment of any previously outstanding amounts. While this may increase the problem of the customer and may, in fact, precipitate actions by other creditors, your client would be well advised to look after its own interest and remember the maxim that “Your first loss is your best loss”.

4. CCAA Proceedings

Proceedings under the CCAA are usually initiated by an application for a stay to allow a debtor to have a period of respite from the pursuit of its creditors, both secured and unsecured. The initial stay period is usually for 30 days and is often extended after the initial period for longer periods of time. The stay allows the debtor to focus on stabilizing its underlying business thereby preserving enterprise value, rather than pre-occupying management's time with the concerns of fending off creditors and staying alive on a day-to-day, crisis basis. As with Court-appointed receiverships, the starting point to determine your client's rights is the initial order, and your first call for information should be to the monitor appointed pursuant to the initial order or the monitor's independent counsel.

CCAA monitors also have an obligation to inform all creditors of the proceeding pursuant to s. 11.7(3) of the CCAA, which obligation is often repeated in the CCAA order. Receipt of such a notice by your client will often be the first indication that the order has been obtained.

Tip No. 6: When informed of CCAA proceedings, obtain the contact particulars of the monitor. Obtain information, including the initial order, through the monitor or its counsel.

The monitor reports to the Court and is responsive to the needs and requests of the creditors. The monitor will be called upon to report on the activities of the debtor and these reports and other information received from the monitor can be relied upon by your client and provide reasonably current information.

CCAA initial orders are usually extremely broad and creative, limited only by the ingenuity of counsel. The order will provide that no person can be compelled to supply goods or service after the date of the initial order unless paid for on a COD basis. Holders of true leases, including landlords, are usually granted a form of occupation rent or use payment, but equipment lessors holding financing leases as opposed to true leases have traditionally been less fortunate. Suppliers with contracts of supply will find themselves unable to terminate the supply contract, even for pre-existing breaches, which may be contrasted with the situation under the BIA discussed below. However, no further contribution of goods or services will be required on credit terms.

Tip No. 7: If your client is being adversely treated by the operation of the CCAA stay order, recourse should be had to the Court under the "comeback" clause.

It is the usual practice for a CCAA initial order to have a "comeback" clause which, in effect, states that any creditor may apply to the Court for a variation of the initial order on a certain number of days notice. Before bringing such a motion, it should be noted that a considerable amount of latitude will be granted to a debtor company seeking to restructure its affairs. An initial order is not usually varied unless the effect of the order is to significantly and unfairly prejudice a creditor.

It should be noted that if your client wishes to supply a company operating under a CCAA proceeding, it is free to do so and, in almost all cases, such should be on a COD basis. It should be noted that, in the ordinary case, it is the debtor company that remains in control of its assets and business operations. The monitor does not control the operations nor should the monitor be named as the party being supplied. Except in extraordinary cases, the monitor will bear no responsibility for supplies made after the initial order but, again, a copy of the CCAA initial stay order should be obtained (including any amendments thereto) to verify the powers and rights of the debtor company and the monitor.

Counsel wishing to be kept apprised of developments in the proceeding should be added to the service list which would ordinarily be kept by counsel for the debtor company and/or the monitor. To do so, you will be required to file a notice of appearance in the CCAA proceeding. This is an excellent way of keeping yourself, and therefore your client, informed of developments, particularly important matters such as the delivery of a plan of arrangement, the dates for filing proofs of claim and the dates by which any claims not filed are deemed to be barred. There usually are no cost ramifications to your client in merely appearing in the application.

Tip No. 8: In CCAA proceedings, stay informed. Get on the Service List.

5. BIA Proposal

In a proposal proceeding under the BIA, a trustee forms a function analogous to that of a monitor in a CCAA proceeding. The trustee has a duty to serve a notice of the proceeding on all creditors

within five days of the filing of the notice of intention to make a proposal pursuant to s. 50.4(6) of the BIA. Although the trustee has a duty to assist the insolvent debtor in developing its proposal, it also has a duty to monitor the debtor for the benefit of the creditors. The trustee is as reliable a source of accurate information as a monitor in a CCAA proceeding.

Unlike the CCAA, which relies upon a limited statutory framework and extensive Court involvement, the BIA relies upon a more extensive statutory framework which avoids the necessity for many of the orders necessary in a CCAA proceeding.

Tip No. 9: BIA = COD. Also, when a BIA proposal is involved, familiarize yourself with Part III, Division I of the BIA.

The BIA establishes that no person may be compelled to advance further money or credit and, accordingly, COD terms are the order of the day for ongoing supply. The BIA does not restrict a supplier's ability from supplying credit, but it would be highly unusual to do so and any credit supplied would be at a high degree of risk.

Section 65.1 of the *BIA* provides that where a notice of intention or a proposal has been filed in respect of an insolvent person, an agreement to supply goods cannot be terminated or amended because of insolvency or because a notice of intention or a proposal has been filed unless the supplier can demonstrate that the operation of 65.1 would create "significant financial hardship". The requirement to continue to supply should not be confused with a requirement to continue to extend credit to the insolvent customer. That is, the supplier is entitled to demand COD payment for the new goods that they continue to supply throughout the stay. No demand is allowed, however, for credit extended prior to the stay period[2].

[2] *Re 728835 Ontario Ltd.* (1998), 3 C.B.R. (4th) 214 (C.A.).

Unlike the CCAA, however, the rules requiring continued supply are, in practice, less onerous than they may seem. The only grounds for termination which may not be used are the fact of the debtor's insolvency and the fact that the debtor has had recourse to the BIA. All other grounds of termination, which typically will include non-payment, are preserved.

If there is no agreement between the supplier and the customer then there is no obligation for the supplier to continue to supply goods, whether COD or not. Conversely, if the supplier wishes to continue supplying goods even though there is no agreement with the customer to do so, s. 65.1 is not intended to prohibit this supplier from doing so and requiring payment COD.

6. Bankruptcy

In rare cases, a trustee in bankruptcy will operate a business. Although a bankruptcy trustee has recourse to the assets of the estate for its receipt and disbursements, all such claims are subject to the rights of secured creditors and, accordingly, it would be extremely unusual to provide any credit to a trustee in bankruptcy. COD is the ordinary requirement.

7. Hybrids

Very often, a number of the above situations are combined to achieve particular results. A common example is the appointment of an interim receiver, which is a specific kind of Court-appointed receiver under the provisions of the BIA, in conjunction with a CCAA proceeding or a BIA proposal. An interim receiver is often appointed for the limited purpose of conveying assets to a purchaser. In some cases, such as the recent Euro United proceeding, an interim receiver can be appointed in a CCAA proceeding to replace management in whom the stakeholders have lost faith.[3] As with Court-appointed receivers, the appointment order should be reviewed to determine whether and on what terms an interim receiver in such circumstances may ask for credit, whether financing has been arranged and whether the interim receiver has a first charge on the assets in the receivership for its receipts and disbursements. If so, the client supplier should be comfortable in continuing to supply the interim receiver even on limited credit terms if necessary or desirable.

[3] Order of the Honourable Mr. Justice Blair dated December 24, 1999, unreported.

Another example of a hybrid includes a private receiver which is confirmed by Court order. This is not to be confused with a Court-appointed receiver. Very often, particularly in acrimonious situations, a debtor will refuse to recognize the rights of a receiver when privately appointed under a security agreement. In some such cases, the appointing creditor will seek the assistance of the Court to appoint a receiver. However, the creditor may wish to avoid the increase in costs, lack of control and delays associated with a Court-appointed receivership. Instead, an application may be made to ask the Court to confirm by way of declaration that the receiver is properly appointed and has the power to take possession and control of the business and assets of the debtor and to enjoin the debtor from interfering with the receiver's exercise of such rights.

Tip No. 10: Beware the hybrid. Identify the exact nature of the insolvency professional involved by obtaining a copy of the source documents (i.e. appointment letter, Court order or both).

In such a case, the receiver is cloaked with the authority of the Court but the fundamental nature of the receiver does not change from a private receiver into a Court-appointed one. The receiver remains a creature created by contract rather than by Court order even though the contractual rights have been confirmed by Court order. Such a receiver should be treated in the identical fashion as a privately appointed receiver referred to above.

The next portion of this paper will focus on unsecured supplier's rights and remedies with a subsection dealing with suggestions as to how to avoid unsecured status in the future.

B. RECOVERING ON OUTSTANDING CLAIMS or "HOW DO I GET MY MONEY?"

The immediate concern of most unsecured creditor clients is the effect of the insolvency proceeding on their ability to recover their claims. Section 3 below examines in detail their ability to exercise the 30 day right to reclaim goods incorporated into the BIA in 1992, while sections 1 and 2 below describe in general terms the unsecured supplier's position in formal and informal insolvency proceedings respectively.

1. Formal Proceedings: CCAA, BIA Court Receiverships and Bankruptcy

The insolvency of a customer of an unsecured supplier is a distressing and confusing event. Remedies for recovery of outstanding claims are limited but by following the tips and other advice contained above, the true nature of the insolvency proceeding can be identified and the process explained to the anxious client. Furthermore, advice can be given on whether, and if so on what basis, further supply, even on credit, can be made which may have the effect of assisting in the recovery and return to financial health of the insolvent entity or perhaps, at least, the continuation of the business and, therefore, of an ongoing customer, for the benefit of your client.

In all formal proceedings, namely a Court-appointed receivership, a CCAA proceeding, a BIA proposal and a bankruptcy, officers of the court are involved to ensure that the process is conducted appropriately. A Court-appointed receiver has a common law duty to act in the interests of all stakeholders, a trustee in bankruptcy is the statutory representative of the unsecured creditors and a BIA proposal trustee has a duty to monitor the debtor in possession, to report to the creditors and to monitor the proposal process. In all of these formal proceedings, the remedies of the unsecured creditor are stayed with the exception of a right of re-possession in the case of a bankruptcy or a receivership as discussed in more detail below.

In these formal proceedings, the role of the unsecured supplier will usually amount to no more than filing an appropriate proof of claim on a timely basis. To do so, the supplier and its counsel should ensure that the supplier is on the list of creditors being maintained by the insolvency professional. This should be confirmed at the earliest opportunity.

Tip No. 11: If your client did not get a notice of the proceedings on a timely basis, it is likely that the client is not on the formal list of creditors. Steps should be taken immediately to make the insolvency professional aware of the existence of the claim and the contact particulars.

However, it is open to any creditor to become more involved in the formal proceeding by taking such steps as:

- becoming an inspector in the estate of the bankruptcy.

- becoming an inspector under the BIA proposal.
- appointing counsel to become actively involved in a CCAA proceeding or even sitting on or organizing a creditors' committee in such proceeding.

All of these steps will ensure that the client is fully informed on a timely basis of all relevant information insofar as it is possible to do so. This is to be contrasted to the limited options available in a private receivership.

2. Informal Proceedings: Private Receivership

For an unsecured creditor, a private receivership represents the least palatable alternative. The receiver has a limited obligation to give reports under the BIA in respect of the ongoing receivership but, as a practical matter, even such reports are of limited value. The unsecured creditor has no control over the process. If the unsecured creditor's claim is large enough, it may consider bankrupting the debtor with a view to:

- investigating reviewable transactions and fraudulent preferences and conveyances, the benefit of which will likely flow to the estate rather than the secured creditor.
- attacking the security of the secured creditor.
- obtaining information and organizing the unsecured creditors.

However, to do so will involve hiring an insolvency professional and indemnifying its fees and disbursements in light of the fact that in most cases there are very few, if any, unencumbered assets. This cost will often outweigh any advantage to be gained.

3. Using the BIA Section 81.1 Right of Possession

A supplier may repossess goods which have not been paid for within thirty days of delivery to a business which has gone bankrupt or has been placed into receivership, whether private or court-appointed. The supplier must present a written demand for repossession within thirty days of delivery. Unless the purchaser, trustee or receiver promptly pays the entire balance owing, it must allow the goods to be repossessed, provided that, at the time of the demand, the goods:

i) are in the possession of the purchaser or its trustee or receiver;

ii) are identifiable;

iii) are in the same state; and

iv) have not been resold, or been subject to any agreement for sale, at arm's length.

The supplier's right of repossession ranks above all other statutory or common law claims to the goods, except the claim of a *bona fide* subsequent purchaser for value without notice of the repossession demand. The right does not preclude a supplier from resorting to any of its rights under provincial law, except that a supplier who repossesses goods under s. 81.1 is not entitled to be paid for those goods. Where the goods have been partly paid for, the supplier has a choice. It may repossess a proportional portion of the goods relative to the unpaid amount, or it may repossess all of the goods upon refunding the partial payments previously received.

Once the trustee or receiver has admitted in writing the validity of the claim for repossession, the supplier must retrieve the goods within ten days, failing which the repossession right expires. This period may be extended on consent.

As described above, the right of repossession applies only in the event of bankruptcy or receivership. It is inapplicable to restructuring proposals under the *BIA* or the *CCAA*. In order to be entitled to the rights given by s. 81.1 a supplier must strictly comply with its terms. A supplier should present its demand in writing promptly to the trustee or receiver so as to avoid a sale of the goods in question by the trustee or the receiver. The demand can be made via Form 75; however a letter setting out the details of the shipment of goods to the bankrupt has been held to be sufficient.[4] The demand must be made within thirty days after the delivery of the goods to the purchaser and the court will be reluctant to extend the time for making demand despite the fact that it has jurisdiction to do so under s. 187(11) of the *BIA*. The court in Ontario has made it clear it will hold suppliers to a strict interpretation of the requirements of s. 81.1. In particular, Justice Farley of the Superior Court of Ontario has held that since s. 81.1 provides an exception to the general policy of the *BIA* that unsecured creditors should share in assets ratably, the court is required to narrowly construe an enactment that constitutes an exception to the fundamental policy of the *BIA*.[5] Moreover, Justice Farley has held that s. 81.1 confers benefits which did not exist at common

[4] *Re: Rizzo Shoes (1989) Limited* (1995), 29 C.B.R. (3d) 270

[5] *Bruce Agra Foods Inc. v. Proposal of Everfresh Beverages Inc.* (1996), 45 C.B.R. (3d) 169 [hereinafter, *Bruce Agra Foods*]

law, and for that reason, the conditions described by the legislation for the acquisition of those rights are mandatory. This judicial approach has led to such decisions as the *Bruce Agra Foods* decision in which the court held that a supplier could not avail itself of rights under s. 81.1 where an *interim* receiver has been appointed as opposed to a receiver. Moreover, in *Re: Stokes Building Supplies Limited* [6] the court held that it could not be assumed that old inventory was sold prior to new inventory to prove, on a balance of probabilities, that goods on hand were goods supplied within thirty days of demand.

In light of this judicial tendency to strictly adhere to the required s. 81.1, it is worthwhile to focus on the mandatory requirements of s. 81.1 and some of the difficulties involved in satisfying them:

(a) The Goods Must Have Been Delivered to the Debtor

The concept of "delivery" is defined variously throughout the common law and provincial sale of goods statutes. Delivery has been held to include, among other things: the physical transfer of the actual goods, a symbolic transfer of goods, transfer or endorsement of a document of title and delivery of goods to the agent of the buyer. The concept of delivery under s. 81.1 has not been widely considered, but it has been held that when goods are shipped Freight On Board the goods are required to arrive at the place of intended delivery in order for delivery to be complete.[7] As a consequence, the thirty day period ran from the date of arrival of the goods, not from the date of delivery to the carrier. Other decisions have also suggested that delivery is not effective until the goods are physically received by the purchaser.

(b) The Supplier Presents A Written Demand For Repossession To The Purchaser, Trustee Or Receiver In The Prescribed Form Containing The Details Of The Transaction

The supplier must present a written demand for repossession to the purchaser, trustee or receiver in the prescribed form containing the details of the transaction. The form requires the following information:

i) the name of the debtor in bankruptcy or receivership;

ii) the name of the purchaser, trustee or receiver;

iii) the name of the supplier;

[6] (1994), 30 C.B.R. (3d) 36

[7] Re: *Zachary's Furniture Ltd.* (1994), 24 C.B.R. (3d) 238 (S.C.)

iv) a description of the goods sufficient to enable them to be identified;

v) identity of the purchaser, dates of sale and delivery of the goods; and

vi) date of the bankruptcy or receivership.

There have been cases which have held that, as long as the information required by the form is provided, albeit in the form of a letter, the demand does not need to be issued on the actual form. This is consistent with case law under the *Interpretation Act* which provides that deviation from a prescribed form is to be permitted where the deviation would not affect the substance of the form used. The substance of the demand is found in the text of the law and not in the form itself.

(c) Demand Must be Presented Within Thirty Days of Delivery

The thirty day time limit for presentment of a claim has been considered in many cases. The court has held that when considering legislation such as s. 81.1 it must proceed in a very cautious manner on a case-by-case basis and the court must be careful to make certain that nothing is done that would upset the scheme of distribution set out in the bankruptcy legislation.

(d) The Purchaser Must Be Bankrupt or a Receiver Must Have Been Appointed

s. 81.1 does not apply unless the purchaser is bankrupt or unless a receiver has been appointed. A bankrupt person is one who has made an assignment in bankruptcy or against whom a receiving order has been made. The requirement of a bankruptcy or the appointment of a receiver as a precondition to the operation of s. 81.1 is very relevant where some form of judicial or statutory stay is in effect by reason of insolvency proceedings. The effect of such stays is often to prevent the appointment of a receiver or the bankruptcy of the purchaser. In the context of proceedings under the *CCAA*, in *Re: Woodward's*[8] the British Columbia Supreme Court was faced with an application where the suppliers requested the creation of a trust fund which would be equal to the monetary value of goods supplied within the thirty day period prior to the granting of the *CCAA* order. The court held that the creation of the trust fund would

[8] *Re: Woordward's Ltd.* (1993), 100 D.L.R. (4th) 133, (hereinafter *Woodward's*).

give suppliers an advantage over other creditors of *Woodward's*. It also held that there was no justification for the creation of the trust fund apart from s. 81.1 and the creation of the trust fund would not serve to maintain the status quo but it would give suppliers an unfair advantage over other creditors. In addition, creation of the trust fund would hinder the reorganization by diverting funds otherwise necessary for the reorganization.

Alternatively, where a supplier is faced with a proposal or a notice of intention to make a proposal under the *BIA*, suppliers can bring an application under s. 69(4) of the *BIA* to lift the stay imposed. This would allow the supplier to either appoint a receiver or petition the purchaser into bankruptcy and therefore take advantage of the s. 81.1 provisions. The lifting of a stay under s. 69.4 is not an easy task to accomplish and a heavy burden of proof will be on the supplier. This is evident in the words of Justice Farley in *Bruce Agra Foods* where it was held that the purpose of s. 81.1 is to protect the unpaid supplier against the unfair consequences of liquidation but not to disrupt re-organizations proposed pursuant to the *BIA*.

(e) When A Demand Is Presented, The Goods Must Be In The Possession Of The Purchaser, Trustee Or Receiver

It has been held that where the goods claimed by the suppliers were in possession of a third party that was not a trustee and not a purchaser or receiver (the third party was a warehouse holding a possessory lien under the *Repair and Storage Liens Act*) s. 81.1 has no application.[9]

(f) When The Demand Is Presented The Goods Must Be Identifiable And Must Not Have Been Fully Paid For

Identification of the goods claimed by the supplier is critical to the operation of s. 81.1. The onus is on the supplier to establish, on a balance of probabilities, that the goods are identifiable. The identification need not be apparent on the face of the goods (i.e., there is no necessity for serial numbers of other distinctive stamps, though these would be advantageous). Identification can come from records such as invoices, purchaser orders and from the evidence of a representative of the supplier or purchasers.

[9] *Thomson Consumer Electronics Canada Inc. v. The Consumer's Distributing Inc.* (Receiver of) (1996), 43 C.B.R. (3d) 77 (Ont. Gen. Div.) [Commercial List]

Section 81.1 does not confer a broad discretion on the court to make a general equitable adjustment between claimants and the trustee. Nor can the court allocate the goods on the assumption that old stock is sold first. The items which are to be taken pursuant to s. 81.1 must themselves be identifiable.

Co-mingling of goods is fatal to the supplier's request. It has been held that where concentrated orange juice from one supplier was poured into vat which contained concentrated orange juice from other suppliers, the goods supplied from the first supplier could not be identified within the meaning of s. 81.1[10]

(g) When A Demand Is Presented The Goods Must Be In The Same State As They Were On Delivery

There area great many ways in which the "state" of a good may be altered subsequent to its delivery to a purchaser so as to defeat s. 81.1. Some of these include, but are not limited to:

i) the application of a process to the goods such that its physical characteristics are modified. For instance, a good may be molded, cut, shaped, frozen, etc.;

ii) the integrity of the good may be retained but the good itself may be divided into smaller parts. For example a drum of motor oil may be emptied and the oil placed into smaller containers;

iii) packaging may be added, altered or removed;

iv) the good supplied may be installed or fixed to other goods such as to become an accession to that other good;

v) the good supplied may be attached or affixed to real property such as to become fixtures;

vi) the goods supplied may be co-mingled with other goods such as the inherent quality of the component goods are lost in the mass;

vii) the goods supplied may be damaged; and

viii) the processes of nature may intercede to alter the state of a "living" good. For instance, the seedling may become a flower, the shipped cattle may have died.

[10] *Bruce Agra Foods, supra.* Note 8

Definitive principles for the determination of when the state of a good is altered will evolve on a case-by-case basis. One decision considers the issue of whether the removal of bulk shrink-wrap constitutes a change to the packaging of goods and not a change to the state of the goods themselves. It has been held that the removal of the shrink-wrap does not constitute a change of the state of the goods for the purposes of the section.[11]

(h) When Demand Is Presented, The Goods Must Not Have Been Resold At Arm's Length And Cannot Be Subject To Any Agreement For Sale At Arm's Length

At the time when written demand is presented under s. 81.1 the goods must not have been resold at arm's length nor be subject to an agreement for sale at arm's length. Sections 3 and 4 of the BIA deal with arm's length transactions. Persons related to each other within the meaning of s. 4 are deemed not to deal with each other at arm's length. If an agreement of sale has been entered into by the debtor at arm's length prior to the appointment of a trustee or receiver, amendments or additions to the agreement by the trustee or receiver will not terminate the agreement or take away the exemption to s. 81.1. However, where the contract for the sale of goods to a third party was vague and uncertain and fell short of the requirements for a legal contract, it has been held that there was not a sale at arm's length wherein the creditor made demand for the return of its goods.[12] In that case, the creditor was therefore entitled to the return of its good or payment for them. In addition, if the goods have been completely paid for by the debtor the rights under s. 81.1 cannot be exercised.

4. Given the Deficiencies of Section 81.1, How Does a Supplier Protect Itself?

A careful examination of the requirements under s. 81.1 reveals that it is only in very specific cases that it will afford sufficient protection to clients that are unpaid suppliers. To the extent that clients are willing to be proactive in order to avoid the pitfalls of becoming an unpaid supplier the following strategies should be kept in mind:

[11] *Thomson Consumer Electronics Canada Inc. v. Consumers Distributing Inc.* (Receiver of), *supra*, Note 12

[12] *Scalbania (Trustee of) v. Wedgewood Village Estates Ltd*.(1989), 74 C.B.R. (N.S.) 97 (C.A.) on a leave to appeal to S.C.C., refused

i) wherever possible, serial numbers should be recorded on invoices to help identify goods. Once goods become co-mingled with those of other suppliers and cannot be positively identified, seizure will be impossible.

ii) when payments are received from troubled customers they should not necessarily be categorized as COD unless those were the terms agreed. In the absence of an agreement to the contrary, payments should be applied to the oldest outstanding invoices. This way, outstanding indebtedness owed to the supplier is most heavily allocated to the most recently shipped goods thereby maximizing the value of goods recoverable under s. 81.1.

iii) as soon as the client becomes aware of the debtor's bankruptcy or receivership the client should determine whether it has delivered, within the last thirty days, goods which remain unpaid. If so, the client should consider visiting its customer's premises, identifying their goods which are available for seizure under s. 81.1 and presenting demand for repossession of goods in the statutory form to the trustee or receiver without delay.

(a) Purchase Money Security Interests (PMSI's)

The best advice, of course, to clients who wish to avoid the pitfalls of being an unpaid supplier, and therefore an unsecured creditor, is to obtain some form of security. Particularly in the case of suppliers of inventory and equipment, provincial personal property legislation (in Ontario the *Personal Property Security Act*) provide for PMSI's. The best method of securing the interest of a seller of goods sold on credit is for the purchaser of such goods to enter into a security agreement under which the purchaser grants to the seller a PMSI in the goods supplied or to be supplied by the seller. A PMSI is a special kind of security interest granted to a party who extends credit to enable the purchaser to purchase the goods.

Provided that all necessary steps are taken to fully comply with the provisions of the *PPSA*, the PMSI will have priority over the interests of all other creditors in that collateral of the purchaser, whether those creditors are secured or unsecured, including those secured parties that had registered financing statements against the purchaser prior to the registration of a financing statement by the PMSI holder**.**

Once a PMSI is obtained and certain procedural requirements are met, no additional security documentation will be required to secure the payment for future shipments. For practical purposes, a PMSI must be created by a signed security agreement. The security agreement can be drafted to create both a general security interest in all of the purchaser's assets and a PMSI in the collateral supplied by the seller. Alternatively, and more commonly for inventory suppliers, it can be drafted to create only a PMSI in the collateral supplied by the seller. A creditor can obtain a PMSI in an inventory or in any other collateral it supplies or finances. The goods that a creditor will usually take security in are inventory, equipment and consumer goods.

(b) Consignment Goods

Another key way for a supplier to avoid the pitfalls of being an unsecured creditor is to supply goods on a consignment basis. If goods are delivered on consignment, the relationship between the parties is not one of vendor and purchaser but of consignor and consignee and title to the goods continues in the consignor. Whether there is a "consignment agreement" or a "sale agreement" is a question of law and the burden of proving that a consignment agreement exists is on the consignor. The court will look at various elements of the transaction to determine if the facts amount to a consignment situation. Although the intention of the parties is relevant, it would be up to a court to look at the facts and determine what the true intent of the parties was at the time of the transaction. This intent will therefore be determined by the substance and the conduct of the parties. The following have been held to be indicators of a true consignment agreement:

1. the words 'on consignment' appear on the invoice and there are no terms of payment;

2. a consignee is ordinarily engaged in the business of selling those products which were provided to him;

3. the consignee was given possession of the goods for the purpose of sale;

4. the consignee was to keep the goods and the proceeds of sale of the goods separate from other

goods and proceeds of sale of other goods and the goods are carried as consignment goods in the consignee's books;

5. the consignee was permitted to sell the goods for such price as the consignee saw fit;

6. at regular intervals, the consignor checked the goods on hand;

7. after selling the goods the consignee was to account to the consignor for the proceeds of sale, after deducting his or her own compensation;

8. the consignee was only obliged to account to the consignor for goods that were sold;

9. the consignor had the right at any time to the reclaim of the goods, and the consignee had the corresponding right at any time to return the goods;

10. any unsold goods had to be returned to the consignor.

Wherever practical, it is advisable for the supplier to conduct a search of any registered secured creditors and request that such creditors acknowledge that goods are being supplied to the customer on consignment and that such goods are not subject to the creditor's security agreement. While this step is not necessary to establish a true consignment, it may prevent such creditors from later challenging the validity of the consignment arrangement with the customer in the event of the customer's bankruptcy or insolvency.

If the consignee becomes bankrupt or insolvent and the agreement is found to be in the nature of a true consignment then the consignor is entitled to possession of any of the goods which can be identified. If the goods have been sold, the consignor is entitled to the proceeds thereof to the extent that they are identifiable or traceable. To the extent that the consigned goods are not identifiable or the proceeds are untraceable, the consignor becomes an ordinary unsecured creditor of the bankrupt estate with respect to such goods and/or amounts.

CONCLUSION

Practitioners often do not have the luxury of time when called upon to give advice to clients concerning insolvency matters. It is therefore important that legal advisors are able to establish quickly and with certainty the relevant facts. Using the tips described in this paper, the practitioner will know who to call, what questions to ask and, most importantly, whether and to what extent a responsible professional owes obligations to his unsecured client. In addition, the practitioner will be able to advise as to whether the supplier has any right to reclaim its goods. Finally, some suggestions are offered as to ways in which the client can avoid these circumstances in the future.

All of the above will enable the practitioner to answer the questions:

1. “Can I continue to supply and on what terms?”;

2. “How can I get my money or goods back?”; and

3. “How can I avoid this in the future”?

Armed with the above analysis and, in particular, the highlighted “Tips”, the practitioner can comfortably provide the practical advice the supplier client wants and needs.