What To Do When Your Supplier Or Client Is Insolvent

In a changing economy, companies are constantly facing new challenges, and none are immune to insolvent suppliers or clients.

It is therefore crucial to be able to identify the early warning signs of a company's insolvency and to be aware of the issues that can arise when a client or a supplier becomes insolvent.

When Insolvency Looms on the Horizon

Late payments for the delivery of products or services are the most common indicators of a company's insolvency. Over time, the persistence and/or worsening of the situation constitutes an even stronger indicator of a client or supplier's potential insolvency.

When a company becomes insolvent, it can claim protection under the *Bankruptcy and Insolvency Act* ("**BIA**") or the*Companies' Creditors Arrangement Act* ("**CCAA**"). Together, these two acts make up the main framework for Canada's insolvency process.

The BIA establishes not only a liquidation scheme for the company, but includes provisions for restructuring measures as well. In contrast to the BIA, the CCAA's primary goal is to restructure and reach agreements with creditors of companies whose debts exceed $5M.

Under each of these acts, the first step in the process is a stay of proceedings ("**stay**") and the appointment of an officer of the Court to oversee the process (trustee (BIA) or monitor (CCAA)). The stay prevents the enforcement of the insolvent company's (the "**debtor's**") obligations existing before it sought protection under the BIA or the CCAA, the continuation or institution of legal proceedings against it, and (in situations involving restructuring, rather than ordinary bankruptcy) the termination of contracts to which it is a party.

Disclaimer of Contracts

Once under the protection of the CCAA or the BIA for restructuring purposes, only the debtor can terminate contracts to which it is a party, insofar as those contracts prove to be too costly or insofar as their termination is beneficial to the restructuring process. With the authorization of the trustee/monitor of the Court, the debtor can send a notice of termination to its co-contractor. The co-contractor will only be able to contest the termination if the abovementioned conditions are not met, or if it can demonstrate that the termination would lead to serious financial difficulties. The rights of the party whose contract is terminated against its will are limited to filing a proof of claim for the amount of damages resulting from the termination.

Suppliers

Once the process has been initiated under the CCAA or the BIA, the debtor's suppliers cannot refuse to deliver goods or services and cannot terminate long-term supply agreements. That said, suppliers can stop accepting further orders if the debtor previously proceeded solely via purchase orders and without any specific agreement setting out the terms and scope of the relationship.

Furthermore, suppliers cannot claim the payment of arrears owing prior to the date on which the stay comes into effect. Nonetheless, suppliers do have the right to request immediate payment for goods delivered after the stay comes into effect (a "*cash on delivery*" basis).

That said, the Court can require suppliers deemed "critical" to keep doing business with the debtor under the same terms and conditions as were in effect prior to the stay (including the payment terms). A charge on the property of the debtor, with a priority or not subject to the Court's discretion, can also be granted in favour of a critical supplier to guarantee the payment of the goods delivered or the services rendered after the stay comes into effect. A critical supplier is one whose goods or services are crucial to the debtor's continued operation under the BIA or the CCAA.

Assignment of Contracts

The debtor can seek a Court order stating that existing contracts be transferred to a third party without the consent of the debtor's co-contractor, despite any provisions to the contrary in the contract. This situation arises primarily in cases where the debtor wishes to sell some or all of its assets while continuing to operate and where the relevant contracts must be transferred to the buyer. The transfer will be permitted if the transferee can demonstrate its ability to honour the contractual obligations on a going forward basis and insofar as all monetary defaults existing on the transfer date will be addressed within the timeframe set out by the Court.

Preferences and Transfers at Undervalue

Under the BIA and the CCAA, any transaction that gives preference to a particular creditor to the detriment of others is considered a preference over other creditors. Where the debtor is dealing at arm's length, there is a presumption of preference if the transaction is carried out within a period of three months preceding the stay. Where the debtor is not dealing at arm's length, the period is of 12 months preceding the stay.

Transfers at undervalue may also be disputed. A transfer at undervalue occurs when two parties exchanged goods or services for which the consideration received was conspicuously less than the fair market value. A person with whom the debtor is dealing at arm’s length whose transactions were carried out in the year preceding the stay could be subject to such recourse. The period may be increased to five years if the debtor was not dealing at arm’s length.

The debtor may establish in its proposal (BIA) or arrangement (CCAA), that the provisions regarding preferences and transfers at undervalue do not apply, but this must be expressly stipulated. In the event of a bankruptcy, these provisions will apply automatically.

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