STATUTORY PRIORITIES IN BUSINESS INSOLVENCIES

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Industry Canada
May, 2001

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EXECUTIVE SUMMARY

Federal and provincial legislation in Canada gives some priority to claims of employees and unpaid suppliers. The primary objective of this legislation is to protect involuntary or unwilling creditors and to enhance the recovery of the amounts owed them. This objective is supported by the fact that many private sector creditors with secured interests have actually negotiated loans based on the credit risk and various privately-held information. While the priorities provided to involuntary or unwilling creditors help overcome some fundamental biases in bankruptcy, attention must be paid to the impact that any such priorities might have on credit markets, investment, and economic growth.

Wage earner protection has been a long-standing issue in Canada. Wage earners often face particular difficulties when their employers go bankrupt. The current regime under the *Bankruptcy and Insolvency Act* (BIA) ranks employee claims ahead of ordinary creditors, but behind secured creditors. Stronger protection for wage earners in bankruptcies has been advocated for years. Options to increase this protection include full or partial super priorities and wage protection funds.

A super priority regime would provide substantially stronger protection to wage earners than is presently available. However, this protection would not always be complete. Furthermore, it would not be prompt because the assets of the bankrupt likely would have to be allocated before any payment is made. Such a regime, however, might be efficiency enhancing if it effectively counters labour market pricing failures that cause employees to take on excessive, unknown risks. However, these same super priorities would shift the risk of unpaid wages to secured creditors. This might result in reduced credit availability, increased lending costs, and thus impact negatively on overall employment.

A wage earner protection fund has the advantage that it would provide prompt and sure payment. One main issue with such a fund is who would pay: employees, employers, taxpayers generally, or a combination of these. Another concern with a fund is that it raises moral hazard problems because those involved would not have any incentive to monitor the financial status of an employer. In addition, there could be considerable administrative costs involved in managing a fund.

Pension fund claims may be better protected in bankruptcies than are wage claims. However, pensioners are still exposed to losses, as was shown by the events in the Royal Oak Mines insolvency. Super-priorities or fund schemes could also be applied to pension fund claims to enhance protection.

Since 1992, the BIA has allowed **unpaid suppliers** to repossess goods delivered just before bankruptcy. However, the protection has been criticized as arbitrary, ineffective and costly to administer. Options to improve the system include extending the repossession rights for unpaid suppliers to encompass reorganizations and adjusting the timing limitations for making a claim.

Another option would be to introduce statutory charges to the current assets or to all of the assets of the buyer. Statutory charges such as these would avoid important problems with respect to repossession rights by providing more effective protection to suppliers, being applicable to both goods and services, protecting suppliers in reorganizations without depriving reorganizing debtors of essential material, and being easier to administer.

I. INTRODUCTION

Federal and provincial legislation in Canada protects the claims of employees and unpaid suppliers. Protection is sometimes provided by giving these claims priority over those of competing creditors. A variety of devices are used, the most important being statutory security interests and deemed trusts.[1] In some instances, creditors are protected by allowing them to claim against persons other than their immediate debtor.

The primary motive behind these protective measures is fairness. The groups who receive the protection are seen as involuntary or vulnerable creditors who sometimes do not have the same information or are less able to manage credit risks than other creditors who have actually negotiated loans based on the credit risk and other information about the debtor. Most of these creditors can quickly and easily take security in all types of real and personal property, including tangible property and property acquired in the future by the debtor. Without statutory protection, some vulnerable, involuntary creditors might recover few if any assets in a bankruptcy.

While statutory priorities help overcome some fundamental biases against involuntary creditors in bankruptcy, attention must be paid to the impact that any such fairness adjustment might have on credit markets, investment, and economic growth. In providing priorities to involuntary or vulnerable creditors, there is an increased risk placed on other, secured creditors.

Sometimes the impact of the reallocation of the risk through a priority scheme can be value enhancing. This can be the case where the risks are shifted to creditors who are better able to collect pertinent information and to manage risks. It can also be value enhancing when the new priorities address market failures caused by the lack of knowledge or powerlessness of the protected creditors. In some cases, fairness can be improved as can overall economic efficiency.

In other cases, the creditors upon whom the added risks are imposed cannot effectively manage them and they respond by substantially raising the cost of loans and restricting overall credit. As a result, investment can be reduced, supply contracts reduced, and less employment created than otherwise would be the case.

A consideration of these tradeoffs is crucial in the development of good bankruptcy law. This paper will examine and assess options to address the issues of unpaid wages and supplier rights. The sections will examine, for discussion purposes, the impact of these options on the fairness and efficiency of insolvency law.

II. WAGE AND PENSION PROTECTION

[1] Deemed trusts are intended to give the Crown the priority rights of a property owner rather than those of a secured creditor.

A. Issues

Wage earners face particular difficulties when their employers go bankrupt, leaving wages unpaid. Employees are among the most vulnerable creditors and can ill afford the loss of their wages. They lack the information to effectively assess the risk that their employers may go bankrupt. Further, they also lack the bargaining power to obtain protection in case of employer bankruptcy. Therefore, protection may be warranted, but it must be recognized that the costs of providing greater protection must be paid by some other group. If protection is provided through super priorities, the costs will be imposed on other creditors. If a fund is set up to pay wages, the costs will be imposed on employers, employees, tax payers generally or even other creditors, depending on how the fund is financed. This raises immediate fairness issues as to how the costs of compensating unpaid wage earners should be allocated.

Providing wage earner protection also raises efficiency issues. Those upon whom the risks of employer bankruptcy are imposed adjust their behaviour to alleviate those risks. This adjustment could impact on credit availability, employment and investment.

Similar considerations apply with pension fund claims as with wage claims. Employees in pension plans and pensioners are vulnerable. They lack the knowledge to assess the risks of employer failure to pay its pension obligations and they are able to do little to protect themselves in any event. Employees are also unable to easily bear the losses to their pensions. While pension fund claims are better protected than wage claims, the protection is not complete. For example, employers are subject to fairly stringent requirements to make payments into pension funds and the pension fund administrators can be counted on to protect employees' interests to some extent. Furthermore, relatively strong priorities have been given to pension fund claims. Despite these protections, incidents such as the Royal Oak case still occur, in which a substantial under funding of the employee pension fund emerged, exposing pensioners to a loss, originally thought to be 25 percent, which after recovery was held to 9 percent. For these reasons, a degree of protection in bankruptcies may be warranted.

Measures to protect pension fund claims raise both fairness and efficiency issues: how should the costs of compensation be shared? How will protective measures affect credit availability, employment and investment?

This paper sets out four different models of wage earner protection. These models are the current Canadian bankruptcy system, the current U.S. bankruptcy system, super priority wage claim systems and wage earner protection funds. The three models for providing protection for pension fund claims that will be examined include the current Canadian regime, a super priority approach and funded protection schemes.

B. Model Features and Assessment

a) Current Canadian Regime

<u>Features</u>

The *Bankruptcy and Insolvency Act* (BIA) gives preferred status to up to $2,000 in wage claims for services provided in the six months immediately preceding the employer's bankruptcy and up to $1,000 for disbursements by salespeople.[2] As a preferred claim, wage claims rank ahead of claims of ordinary creditors, but behind those of secured creditors.

A very limited form of super priority for wage claims is provided in the federal *Bank Act*. Section 427 of that Act gives claims for wages earned within three months before bankruptcy a priority over a security interest which a bank may have taken under that section. However, in most provinces banks can circumvent this wage priority by taking a security interest under provincial legislation.

Provinces also have established statutory security interests and deemed trusts covering wage claims which give these claims priority over the claims of secured creditors.[3] However, in most cases these devices do not operate in bankruptcy, as the BIA provisions take precedence over the provincial legislation and limit wage claims to a preferred status. Liens under provincial builders' liens legislation are an exception. These liens, which protect employees of contractors and subcontractors, are recognized by the BIA.

Wage earners also receive protection through federal and provincial directors' liability legislation. Directors are liable to employees for up to six month's unpaid wages under the *Canada Business Corporations Act*. The *Canada Labour Code* provides that directors of a corporation are jointly and severally liable for wages as well as termination and severance pay, to a maximum amount equivalent to six months' wages. Directors are also liable for the unpaid wages of employees under most provincial corporate and employment standards legislation. In some cases the liability for unpaid wages is absolute, there is no due diligence defence[4]

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[2]S.136(1)(d). See Table "A".

[3] Provincial wage protection devices include judicial collection proceedings whereby an employer may be ordered by the court to pay wages, or a public agency may be authorized to investigate a claim for unpaid wages, order payment and have the order enforced. Some provinces require employers in certain situations who have failed to pay employees to provide letters of credit or bonds.

[4]See Industry Canada's discussion paper "Efficiency and Fairness in Business Insolvencies" Chapter 1 for a discussion of directors' personal liability for wages.

With respect to pension fund contributions, claims against an employer can include claims for unremitted employer contributions, employee contributions deducted by the employer but not remitted to the fund, and unfunded liabilities which can arise where lower than expected returns on investment do not enable the fund to meet its obligations. If an employer goes bankrupt, it may have sizable unfunded liabilities.

Unlike wage claims, the BIA assigns no express priority to pension fund claims. Protection for these pension fund claims is provided in federal and provincial pension legislation. The federal *Pension Benefits Standards Act* (PBSA) requires employers to hold money due to a pension fund, including employer and employee contributions, in trust and provides that these amounts are deemed to be held in trust if the employer becomes bankrupt. In most provinces, pension legislation deems an employer to hold unremitted employer and employee pension plan contributions plus unfunded liabilities of a pension plan in trust and gives a pension fund a lien against the employer's assets. It is more likely that provincial deemed trusts and liens regarding pension assets would apply in bankruptcy than those covering wage claims. However, it is by no means certain.[5]

The Ontario *Pension Benefits Act* (PBA) also provides funded protection, establishing a "Guarantee Fund" out of which shortfalls in pension funds can be compensated. Specifically, the Fund is given a lien against the assets of the employer responsible for the shortfall. Such funded protection appears to be unique to Ontario.

Directors' liability provisions are also used to protect pension fund claims. Under the Quebec *Supplemental Pension Plans Act*, for instance, directors are directly liable for unpaid contributions to pension plans.

b) Historical Regime

Wage protection has been a long standing issue in Canada. The 1949 *Bankruptcy Act* ranked wage claims for up to $500 fourth among preferred claims. When the Tassé Committee[6] submitted its report in 1970 it did not identify any major problems with the 1949 wage earner protection regime. It recommended only that the amount of wages protected be increased to $1,000 in order to reflect post-1949 inflation.

Bill C-60, tabled in 1975, went further. It proposed full super priority protection for up to $2,000 in wage claims and imposed absolute liability on corporate directors for up to $2,000 in wages per employee. The Standing Senate Committee on Banking, Trade and Commerce

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[5]Unlike wage claims, pension fund claims are not given preferred creditor status in the BIA and it can be argued that the BIA has not precluded a province from granting higher status to them. However, the Manitoba Court of Appeal in Continental Casualty Co. v. MacLeod Stedman Inc., (1996) CarswellMan 537, 141 D.L.R. (4th) 36 (Man. C.A.) ruled that provincial deemed trusts do not apply in bankruptcy.

[6]The Study Committee on Bankruptcy and Insolvency Legislation, chaired by Roger Tassé, was appointed by the Justice Minister in 1966 to review Canada's bankruptcy and insolvency legislation.

recommended that the super priority provisions be deleted from the Bill. The Committee took the position that a super priority system would seriously disrupt the commercial lending system and would hamper credit availability, especially to labour intensive industries. The Committee also noted that a super priority would ensure neither prompt nor certain payment of wages. It proposed instead that a government administered fund be created to pay wage claims. That fund would be financed through employer and employee contributions and would compensate claims up to $2,000. However, Bill C-60 was never passed.

Between 1978 and 1984 five more bankruptcy bills were launched, none of which were enacted. All of these bills would have given preferred creditor status to wage claims. In reviewing Bill C-12 in 1980, the Standing Senate Committee on Banking, Trade and Commerce found the proposed wage protection to be unsatisfactory. The Committee assessed what it viewed as the three main options for increasing wage earner protection: full super priority, modified priority and a wage earner protection fund.

Under full super priority, the claim for unpaid wages would be placed ahead of all other debts for payment. The modified priority option, on the other hand, would place wage claims ahead of all other claims on working capital, but they would not take priority over other previously secured interests. The third option, a wage earner protection fund, would have provide up-front coverage for any unpaid wages.

The options were assessed against four criteria: certainty of payment, promptness of payment, ease of administration and impact on credit availability. The Committee concluded that full super priority failed to meet any of these criteria. It found that modified priority would provide even less certain protection to workers and, like full super priority, it would still reduce credit availability. On the other hand, the Committee concluded that modified priority would be easier to administer. The Committee favoured the wage earner protection fund approach as providing certain and prompt payment, not being overly complex to administer, and having no adverse impact on credit availability.

Continuing the search for a solution to the wage earner protection problem, the Minister of Consumer and Corporate Affairs established the Landry Committee in 1981 to determine the best way to protect wages in insolvency. The Landry Committee report[7] recommended the implementation of a wage earner protection system in two stages. In the first stage, lasting three years, claims for up to $1,000 in wages and pension plan contributions would have been paid out of federal government revenues. Meanwhile, a second stage regime would have been developed which would have provided certain and prompt payment without disrupting the distribution of a bankrupt employer's assets.

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[7] "*Wage Protection in Matters of Bankruptcy and Insolvency*".

Bill C-17, the last of the six bankruptcy reform bills introduced in Parliament between 1975 and 1984, did not adopt the Landry Committee recommendations. Instead, it retained the preferred creditor solution. This provided preferred creditor status to up to $4,000 in wage claims. Amendments subsequently were introduced at the Committee stage to provide super priority for up to $4,000 in wage claims. Ultimately, Bill C-17 was not enacted.

In 1985, the government adopted a different approach to bankruptcy reform, one which focussed on amending the existing legislation rather than trying to rewrite the law completely. It appointed the Colter Committee[8] to identify required amendments. In 1986, the Colter Report identified a number of problems with the existing wage earner protection provisions, including their failure to provide certain and prompt payment. The report considered super priority, modified priority and wage earner protection fund options. Echoing the Senate Committee on Banking, Trade and Commerce, the Colter Committee rejected super and modified priority, preferring a wage earner protection fund financed by modest contributions from both employers and employees. This choice was made in part because of the uncertainty and delay in payment to workers which would have occurred under either the super priority or modified priority schemes.

Wage earner protection was examined again in 1989 by the Advisory Council on Adjustment[9], chaired by Jean de Grandpré. The Council suggested that a wage earner protection fund be created and financed either by levies on employers or out of general government revenues. The de Grandpré Council recommended that the fund compensate claims for unpaid wages and pension premiums of up to $4,000.

Bill C-22 was introduced in 1991. It proposed a wage earner protection fund financed by a tax on employers. The Bill provided that employees would be paid 90 percent of their unpaid wages, up to $2,000. The House of Commons Standing Committee on Consumer and Corporate Affairs and Government Operations, which reviewed Bill C-22, was opposed to a tax-financed fund except as a last resort. The Committee took the view that wages should be paid out of the employer's assets to the extent possible and it recommended that up to $3,000 in unpaid wages be given priority over the claims of all other creditors. It also recommended that a fund be established to cover any shortfall.

The government did not adopt the Standing Committee's recommendations. Instead it removed the wage earner protection provisions from Bill C-22 and increased the existing provisions of the BIA. In particular, the preferred creditor status for up to $500 of wage claims was increased to $2,000.

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[8] The Advisory Committee on Bankruptcy and Insolvency, chaired by Gary Colter, was appointed by the Minister of Consumer and Corporate Affairs in 1985.

[9] The Council was established by the federal government to examine ways to of maximize Canadian advantage from the Canada-US Free Trade Agreement, identify adjustment issues raised by the Agreement and recommend measures to facilitate adjustment. It made a number of recommendations for labour adjustment, including measures to compensate workers in employer bankruptcies.

These provisions came into force on November 30, 1992. When Bill C-22 was enacted, the intent of the sponsoring Minister was that a Special Joint Committee of the House of Commons and Senate be established to examine outstanding wage earner protection issues. However, no such committee was ever established.

In1994, the Bankruptcy and Insolvency Advisory Committee[10] set up a task force to study wage earner protection issues. The task force agreed that workers' wages should be protected, but task force members were unable to agree on the appropriate form of protection. While some members considered that a wage earner protection fund was the most appropriate solution, others preferred the creation of a super priority for wage claims. No significant changes were made to the wage earner protection provisions of the BIA when it was amended in 1997.

As regards pension fund protection, the five bankruptcy bills tabled between 1978 and 1984 provided preferred status for up to $500 in claims. The Landry, Colter and de Grandpré reports were all consistent in recommending that pension contributions be protected in bankruptcy through the funds proposed in the respective reports.

Assessment

Fairness - Wage earners are often among those most at risk in a bankruptcy, with little they can do to protect themselves. They usually work with limited information, have little power to control their situation and have no means of limiting their risk. This places the employees in a very vulnerable position. Their position is made worse by the fact that wage earners can typically ill afford to forfeit their wages, even temporarily.

Current protection for these employees is limited and it fails to make payment either prompt or certain. The BIA does little to discourage employers and other creditors from imposing risks on employees by arranging security agreements which provide lower cost borrowing to employers and security to lenders. While provincial wage earner protection exists and provides stronger protection, such legislation is usually ineffective in bankruptcies.

The BIA does not provide any special protection for pension fund claims. Pensions governed by federal pension legislation receive fairly strong protection, at least so far as claims for contributions are concerned. The deemed trusts place pension fund claims ahead of some secured claims. On the other hand, the lack of priority protection for claims for unfunded liabilities leaves federal sector funds more exposed on those claims. Provincial legislation, with deemed trusts covering unfunded liabilities as well as contributions may provide stronger protection.[11]

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[10]The Bankruptcy and Insolvency Advisory Committee was appointed by the Deputy Minister of Consumer and Corporate Affairs in 1993 to advise the department on bankruptcy law policy.

[11]Ontario, with its Guarantee Fund provides very strong protection.

Efficiency - The lack of knowledge of wage earners about the risks of non-payment of wages and their inability to avoid risk may generate labour market failures. Unlike other creditors, an employee often may not knowingly assume a certain degree of risk with their employment.

The current regime does little to address these potential market failures. It enables some risks to be imposed on wage earners rather than on the major creditors of employers who may be better able to monitor employers, assess risks and adjust to them should the degree of risk worsen. On the other hand, the current regime enables secured creditors to manage the risk of employer default without restricting credit supply, potential investment, and overall employment.

Secured creditors are exposed to more risk on pension fund claims where pension legislation offers some protection. This can be expected to have some impact on credit availability and more so if further protection were implemented.

c) U.S. Regime

Features

The *U.S. Bankruptcy Code* (the *Code*) gives preferred creditor status for up to $2,000 in claims for salaries earned within the three months preceding bankruptcy (see Table "B"). In contrast to Canada, the U.S. bankruptcy law recognizes state statutory security interests covering wage claims, although not all states have enacted such protection.

The *Code* also protects pension contributions, giving preferred status to claims for contributions to worker benefit plans arising from services rendered within six months before bankruptcy.

Assessment

Fairness - The wage protection provided directly by the *Code* is no stronger than that provided in Canada. Where state liens are in effect, employee protection in bankruptcies is stronger than in Canada. However, the U.S. regime does not provide prompt or sure payment.

The U.S. bankruptcy regime does provide more direct federally-legislated protection to pension claims than does the BIA. It also recognizes state protective measures in the same way as the BIA.

Efficiency - The priorities regime in the Code has effects similar to the Canadian regime. It does not impact on secured creditors, although state created liens may shift risks to secured creditors. Generally, any reduction in private sector security will result in more restrictive credit availability and/or higher cost of credit. Consequently, business growth and employment may be negatively affected.

d) Alternative Models for Wage Claims

1. Full Super Priority

Features

Under a full super priority regime, the BIA would give claims for unpaid wages a security interest on all the assets of the employer, including land, equipment, intellectual property and working capital. This security interest would rank ahead of all other claims.[12]

Assessment

Fairness - Full super priority would increase protection for wage earners. Although employees could not be certain of compensation, the likelihood of their getting paid would be much higher than under the current legislation. However, payment would not be prompt as assets still have to be disposed of to secure cash. This could be accelerated if a mechanism is included in this option to allow trustees to borrow against secured assets to pay wages. However, this still relies on there being sufficient assets to pay for wage claims. Furthermore, it does increase the risk to creditors.

Some secured creditors, such as working capital lenders, might be able to effectively manage this risk. However, risk management might be more difficult for long-term creditors. Lenders likely would adjust by reducing credit or increasing the cost of borrowing for high-risk and labour intensive businesses, especially those perceived as high risk. Potentially, employment levels in high risk sectors could fall.

One advantage of this regime is that it would impose no additional direct burden on tax payers. However, it might impose an indirect burden by subordinating priority Crown claims, including claims for source deductions, to wage claims.

Efficiency - Full super priority would increase secured creditor risks and could trigger adjustments. The impact on efficiency would depend on how easily creditors could adjust. Improved efficiency could occur if creditors are able to weed out and cut credit to high risk employers while maintaining good credit availability for strong employers. Alternatively, where secured creditors could not easily adjust, an overall reduction of credit availability could result, probably diminishing efficiency.

In practice, it might be more difficult for long term lenders, such as mortgage lenders, to adjust to super priority. On the other hand, working capital lenders would probably be more

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[12]Employee claims could be given super priority status in receiverships as well. However, the problem is less acute in receiverships and less in need of a federal solution. In most provinces, priorities operate now in receiverships, giving employee claims stronger protection than in bankruptcy and provinces could increase this protection should they wish.

effective in adjusting to super-priorities as they deal more regularly with businesses and are better able to make accurate day-to-day assessments of their financial situations. Nevertheless, if working capital lenders were to routinely apply margining formulae in setting credit limits, as has been suggested would be the case, the efficiency even of working capital credit markets could suffer.

It is also possible that full super priority might increase the costs of administration in bankruptcies. Additional work would be incurred by the trustee to determine the allocation of the compensating wage claims among the various secured creditors, which may in some cases be a complicated task for trustees.

2. Super Priority Limited to Current Assets

Features

Employee claims for unpaid wages could be given first ranking security only over the current assets of the debtor, which would include cash, short term investments, inventory and receivables.

Assessment

Fairness - Although a current assets super priority regime would increase protection for workers, it would not offer as much protection as a full super priority regime. One problem with this regime is that it places a greater burden on working capital lenders than the current regime. Some credit restrictions and loss of employment could result. However, fixed asset lenders would not be affected.

In a current assets super priority regime, there would still be delays in payment to allow for the realization of the debtor's assets, but any delay probably would be less than a full super priority regime, given that only current assets are involved. This option would not require any direct government spending, but there would be an indirect burden on taxpayers as the wage claims priority could reduce funds available for Crown claims.

Efficiency - Adopting a current assets super priority regime could generate efficiency gains where employees are taking on excessive risks of not getting paid and where creditors could adjust without greatly reducing credit availability to employer businesses. Such a system would not affect markets for fixed asset secured credit, which is significant as fixed asset secured creditors might be less able to adjust to any wage super priority applicable to their security. Working capital credit markets would be affected, although working capital lenders probably would be better able to adjust effectively. A super priority regime limited to current assets would generate added administration costs, but less so than a full super priority regime.

3. Super Priority Excluding Purchase Money Security Interests[13]

Features

A super priority system that excludes purchase money security interests would ensure that employee wage claims would have first priority rights against all the employer's assets except those subject to purchase money security interests (PMSIs).

Assessment

Fairness - This regime would give employees less protection than a full super priority. However, it would offer better protection than a current assets priority regime in cases where employers have few current assets, which is not uncommon. As with other super priority systems, it may lead to some credit restriction and loss of employment and payment would be neither certain nor prompt.

Efficiency - Like the other super priority regimes, this regime would reduce labour market failures which may lead employees to bear an excessive risk under the current legislation. Although super priority regimes tend to restrict credit availability, in protecting PMSI lenders against added risk this regime would avoid credit restrictions by this important class of lenders. At the same time, lending by fixed asset, non-PMSI secured creditors for whom the adjustment to super priorities might be difficult, may be discouraged. Like the other super priority regimes, this regime would produce higher administration costs than the current regime.

4. Recognition of Provincial Deemed Trusts and Liens in Bankruptcy

Features

At present, provincial deemed trusts and liens for unpaid wages do not operate in bankruptcy. The BIA could be amended to expressly recognize these provincial priorities for wage claims.[14]

Assessment

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[13] A purchase money security interest is one where a seller takes security in the property sold or where the security interest is in property purchased with funds supplied by the secured party. This model is based on a proposal by Professor R. Cuming in a paper prepared for Industry Canada entitled "Enhanced Enforcement of Wage Claims under Canadian Bankruptcy and Receivership Law".

[14] Where an bankrupt employer had operations in several provinces, it might be necessary to provide for equal treatment of all wage claims, perhaps by providing that the wage claim priorities in the province of the employer's main operations shall apply.

Fairness - Protection would be roughly similar to that provided by the partial super-priority models. While not certain, the protection would be improved over what it is now in bankruptcies. Of course, protection would vary from one province to another.

Efficiency - This model would have efficiency effects similar to those of the super-priority models. It could result in more restrictive lending or higher borrowing costs. It would give other creditors of an employer the incentive to monitor its finances. In providing the same protection inside and outside bankruptcy, it would remove any incentive for creditors to force bankruptcy to improve their priority position with respect to wage claims.

5. Wage Earner Protection Fund

Features

A wage earner protection fund would provide that unpaid wages due to bankruptcy would be paid out of a government administered fund up to a specified maximum.[15] The cost of such protection was calculated at about $10 to $15 million in 1991.[16] Various funding options would be available. The costs could be borne by the employer through an employer tax based on insurable earnings and collected through the employment insurance system for ease of administration. A shared cost option between the employers and the employees is another option.

Administering the payout of benefits under a wage earner protection fund would be fairly costly. In 1991, it was estimated that it would cost about $1.75 million a year to administer payouts in a somewhat larger scheme in which receiverships would be covered and payouts would be in the $50 million range. The relative administrative costs of 3.4 percent would likely be larger under a more restrictive scheme.

Assessment

Fairness - One advantage of a wage earner protection fund is that it would provide certain

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[15] A wage protection fund could be extended to provide coverage in receiverships. The wage protection scheme in the 1991 bankruptcy reform bill provided for this. However, given that provincial protection in receiverships is quite strong now and that provinces could provide funded protection in receiverships should they wish, the need for funding under a federal scheme is questionable.

[16] In 1991 it was estimated that a fund compensating wage claims in bankruptcies and receiverships would cost between $32 and $50 million, plus administration costs. The base cost was estimated at about $32 million, including about $10 million in bankruptcies and $22 million in receiverships. The $50 million cap on the estimate was intended to provide a cushion to cover an expected increase in wage claims due to a fund. A cap of similar proportions on a fund covering only claims in bankruptcies would be about $15 million. However, the possibility that receiverships would be turned into bankruptcies to take advantage of a fund must be considered. This could raise the cost of a fund substantially.

payment of wages up to the limits of protection. However, the need to investigate may cause a delay in payment. The allocation of the financing burden would depend on the method chosen.

Financing by an employer tax would put the initial burden on employers. It is possible that some of the cost would be passed on to buyers of their products through higher prices and backwards on to their employees and suppliers through lower wages and more restrictive buying practices. Absent a tax exemption, the burden would also fall on employers who are unlikely to go bankrupt, such as government departments or agencies, schools and hospitals.

An employer/employee tax based regime would put some of the initial burden on employees. Whether employees could eventually pass this on to employers or to employers' customers would depend on their bargaining power in the specific labour market.

Efficiency - Several effects are possible, depending upon the method of financing such a fund. Those funded by payroll taxes on employers and/or employees would have some effect on employment, but the impact would likely be very small given the relatively modest cost.

Funds would only affect credit availability if they are given super priorities, in which case they would have efficiency effects similar to super priority regimes. Where fund claims were given super priority, creditors would have an incentive to monitor employers, which would enhance efficiency. Without fund super priorities, no one immediately involved in a bankruptcy would have an incentive to manage risk, which could lead to serious inefficiencies and even abuses unless careful monitoring is provided.

6. Employment Insurance Benefits Model

Features

A fifth option, similar to funded protection, would be to entitle the employee to Employment Insurance benefits for the period for which they were not paid. This would require amending the *Employment Insurance Act* (EIA) to recognize as a period of unemployment the time during which an employee worked but was not paid prior to the bankruptcy.

Assessment

Fairness - Under this option payment would be prompt and certain up to the limit of the EI benefits. However, as these benefits are set at only about 55 percent of wages, an employee's protection would be less complete than under the other funded schemes depending upon the cap set for those funds. The burden would be borne by employers and employees through their EI premiums and secured creditors would not be affected unless the Employment Insurance Program was given a priority claim in the employer's bankruptcy.

Efficiency - This regime would generate a very small increase in the payroll tax burden on

employers and employees, with a negligible impact on employment. If the fund is given a priority claim, credit availability could be affected. Given the lower level of compensation under this regime, employees would have more incentive to monitor their employers and to insist that wages be paid when due.

The cost of administering the payout of benefits would be an additional net burden.

e) Alternative Models for Pension Fund Claims

1. Super Priority Protection for Pension Fund Claims

Features

Similar to the wage protection models, one option would be to provide full super priority protection to such claims for both employer and employee contributions as well as for unfunded liabilities. An alternative would be to give pension fund claims a priority over an employer's current assets. Another would be to confirm that provincial priorities operate in bankruptcy.

Assessment

Fairness - Pension fund claims may already have priority status in bankruptcy under federal and provincial pension legislation. If so, the increase in protection under a super priority scheme would be a smaller improvement than would be experienced with wage claims. Nevertheless, super priority would substantially increase protection for pensions within the federal jurisdiction, where claims for unfunded liabilities do not have priority.

The increase in protection in the provincial pension sector due to a federal priority would vary as current levels of protection differ according to the various provinces respective pension legislation. But, the increase in protection would be generally less than in the federal sector, where the existing pension legislation is somewhat less protective. Confirming provincial priorities would make the level of protection more certain.

The most apparent cost of a super priority system would be imposed on secured creditors of the employer. An option to address this issue is the adoption of a super priority over current assets only, as was discussed for wage claims. Such a plan would provide less protection to pensions and would impose no added burden on fixed asset secured creditors.

Efficiency - Similar considerations as those applied to wage claims priorities would apply under this proposal. The new priorities would shift risk to secured creditors and would impact to a greater or lesser degree on current and/or fixed asset secured credit markets. This option would enhance efficiency to the extent that it addresses labour market failures that lead employees to assume excessive risk of employer failure to pay pension contributions. However, amounts owing for unfunded liabilities can be large and difficult to calculate. This leads to a substantial risk coupled with uncertainty, and the impact that such a combination of factors can have on

credit markets

2. Funded Protection for Pension Fund Claims

Features

A further option would be to establish a fund to cover pension fund claims against bankrupt employers that would be financed by employers and employees. The fund would operate in the same way as a wage fund.

Assessment

Fairness - A funded regime would provide certain protection. Who would bear the burden would depend on the source of financing. The burden, or at least part of it, would be shifted to secured creditors if the fund is given a priority claim against the employer.

Efficiency - Payroll tax financed funds would have some impact on employment. Funds given priority rights against employers also could impact on credit availability. The cost of administering the payment of benefits from the fund would be an added burden.

C. Conclusions

Outside bankruptcy, provincial rules provide relatively stringent protection for wage claims. Protection for wage claims in employer bankruptcies in Canada is less strong, being limited to a preferred creditor status in the BIA. Options to increase protection include full or partial federal super priorities, recognition of provincial priorities and a wage earner protection fund.

The establishment of a super priority protection for unpaid wages would increase protection for workers but it would not ensure prompt or certain payment to them. Such a regime might be efficiency enhancing if it effectively counters labour market pricing failures that cause employees to take on excessive, unknown risks. However, these same super priorities would shift the risk of unpaid wages to secured creditors, the uncertainty of which might reduce credit availability, increase lending costs, and thus affect overall employment.

A wage earner protection fund would provide sure payment. One main issue with a fund protection is who would pay: employers and/or employees, tax payers generally or creditors? Another issue is the negative reaction of businesses to another payroll tax, even if a very small one. A further concern is that a fund raises a moral hazard issue because those directly involved would lack any incentive to monitor the financial status of an employer. In addition, administrative costs involved in managing a fund would be high relative to the amount of benefits to be paid. Finally, if a fund scheme were given priority against a bankrupt employer the negative impact on secured creditors and credit availability would be the same as under a

super priority regime.

With respect to pension fund claims, existing protection in bankruptcy maybe stronger than for wage claims. Statutory liens and deemed trusts covering pension fund claims, which are already in place under both federal and provincial pension legislation, provide fairly strong protection, although it is uncertain that provincial protections would be recognized in bankruptcy. Options to increase protection further include establishing a BIA super priority covering claims for contributions and unfunded liabilities, confirming the application of provincial protection for pension claims in bankruptcy or setting up a fund to guarantee payment of those claims. A super priorities regime might negatively affect secured creditors and the credit market, although the impact would be less than for wage claim super priorities. Providing funded protection for pension claims would raise the same financing issues as a wage claim protection fund.

III. UNPAID SUPPLIERS

A. Issues

In 1992, the BIA was amended to give suppliers rights to repossess goods delivered just prior to bankruptcy or receivership. These provisions have been criticized as being ineffective and administratively costly. Some have suggested that more effective measures to protect suppliers should be developed. Others have questioned whether suppliers need special protection at all.

This chapter examines six models governing unpaid suppliers' rights in insolvencies. These include the current Canadian repossession rights regime, the U.S. regime, a model extending repossession rights to cover goods supplied prior to reorganizations and changing the coverage periods, a model making directors personally liable for goods and services supplied just prior to insolvency, a model giving suppliers a statutory security interest for goods and services supplied, and a model providing no special protection for unpaid suppliers.

B. Model Features and Assessment

a) Current Canadian Regime

<u>*Features*</u>

The Canadian unpaid supplier protection regime has several facets (see Table "C"). The repossession rights in the BIA provide direct protection to suppliers in the bankruptcy or receivership of their customers. Measures aimed directly at protecting suppliers are contained in other federal and provincial legislation as well. Indirect forms of protection are also available, including provincial legislation which enables suppliers to protect themselves by taking consensual security in supplied goods. Common law possessory liens provide another form of protection for suppliers.

The BIA enables a person who supplied goods to a commercial buyer to repossess the goods within 30 days of delivery, if the buyer is bankrupt or in receivership, provided that the goods are identifiable, in the same state as when delivered, and have not been resold.[17] A supplier may not repossess goods from a debtor who is in the process of reorganizing under the BIA. However, should the debtor later become bankrupt, the supplier can then repossess goods which had been delivered just before the reorganization proceedings started. The supplier's right to repossess takes priority over all other claims against the goods except for those claims of a bona fide buyer.

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[17]S.81.1.

The BIA also gives suppliers of agricultural, fish and aquacultural produce a charge against the inventory of a buyer for the value of the produce delivered within the 15 days prior to the buyer's bankruptcy or receivership that have not been paid for.[18] The charge applies to inventory on hand at the date of the bankruptcy or receivership and has priority over all other claims save those of a supplier seeking to repossess under the Act.

The CCAA contains no unpaid supplier protection measures.[19] The *Bank Act* protects suppliers of agricultural products to a bankrupt processor. The Act subordinates the security of the processor's bank to the supplier's claim, up to the value of products delivered within six months before the bankruptcy.[20]

Supplier protection is also available under provincial construction and builders' liens legislation, This legislation gives suppliers of goods or services to a construction site liens against the site for the value of goods and services supplied. In addition, the applicable legislation generally requires site owners to hold back a portion of the contract price, provide that the amount held back is put in trust for suppliers, and gives them a lien against this amount. These liens are effective in bankruptcy, giving suppliers the status of secured creditors. Supplier claims even have a priority over claims for mortgage funds advanced after suppliers have registered their liens.

Provincial liens legislation for repairers provides another source of protection. It gives repairers or storers of personal property first ranking liens against that property. These liens also are effective in bankruptcy.

In most provinces, sellers of goods can take purchase money security interests (PMSIs) in goods supplied. Common law liens are yet another source of protection. The common law gives suppliers of goods and services liens to secure the price of materials or services sold. These liens are possessory only; the supplier must retain possession of the goods subject to the lien to make it effective. The BIA recognizes possessory liens where the lien holder has the right to sell the collateral.

b) Historical Development

Prior to the 1992 amendments to the BIA, supplier interests had expressed strong concern about the low recoveries made by unpaid suppliers in bankruptcies of their buyers. Suppliers argued that the ordinary unsecured creditor status to which most supplier claims were relegated in bankruptcies left them unfairly exposed. In support of their requests for better protection, they

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[18]S.81.2.

[19]While there is no explicit protection for suppliers in the CCAA, the courts have given suppliers in CCAA cases protection akin to that provided under the BIA.

[20]S.427.

pointed to the ever increasing use of security by lenders and the corresponding reduction in the pool of assets available to unsecured creditors. They also claimed that in some cases suppliers were victims of fraudulent behaviour by buyer companies, which would stock up on inventory just before bankruptcy to reduce the exposure of their owners.

In response to these complaints, supplier repossession rights in Quebec and the United States were held up as possible models for adoption in the BIA. However, supplier arguments were by no means unopposed. Opponents argued that special treatment for suppliers would distort credit markets, reduce credit availability and complicate the administration of bankruptcy estates. They also argued that suppliers could and should protect themselves by being careful about their customers or by taking security in goods supplied.

The Tassé report of 1970 recommended that protection for unpaid suppliers be added to the *Bankruptcy Act*. This recommendation was based on the objectives of improving equity and establishing uniform protection across Canada. The report proposed a 30 day goods provision similar to that in place at the time in Quebec.

Of the six bankruptcy bills introduced between 1975 and 1984, only the last, Bill C-17, contained any unpaid supplier protection measures.[21] Under Bill C-17, where goods were delivered within ten days prior to the start of reorganization proceedings, bankruptcy or receivership, the supplier would have had up to 30 days after the relevant triggering event to demand repossession. In order to be claimed, the goods would have to have been in possession of the buyer, trustee or receiver, identifiable and in the same condition delivered, and not have been resold. If the goods were co-mingled with similar goods, the supplier would have been able to have reclaimed a portion of the co-mingled stock. The supplier would also have had the right to the proceeds of goods sold between the triggering date and 30 days thereafter.

In 1986 the Colter Committee issued a report on various issues, including unpaid supplier rights. Its report indicated that Committee members from common law provinces were against special treatment of unpaid suppliers. The reasoning for that position was that such treatment would deprive unsecured creditors of their fair share in a bankruptcy and would discriminate between suppliers delivering goods before and after the arbitrary cut-off dates. In contrast, Quebec members of the Committee maintained that suppliers often lacked appropriate market power and that legislative intervention was needed to re-balance the treatment of suppliers and other creditors in order to give suppliers rights that are commensurate with their economic importance.

Ultimately the Colter Committee report recommended that no changes should be made to the BIA respecting suppliers. It recommended instead that provincial legislation giving secured creditor status to supplier claims be recognized in bankruptcy. The report went on to advise that

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[21]These were not in the Bill as introduced. They were introduced by the government at Committee stage. Neither Bill C-17 nor any of the other of the six bills were enacted.

if federal intervention was deemed necessary, the protection provided to suppliers should cover only goods delivered within five days before bankruptcy or receivership.

The current BIA supplier protection provisions were enacted as part of Bill C-22 in 1992. As introduced in June 1991, Bill C-22 did not provide special protection for farmers and fishermen, nor did it offer any assistance to suppliers in reorganizations. The House of Commons Committee examining the Bill[22] supported, after considerable testimony, supplier protection measures. The Committee noted that suppliers could be victims of fraudulent behaviour by buyers stocking up before bankruptcy. It noted that some suppliers may lack the information needed to assess the financial health of buyers and thus are unable to appropriately assess the risk of supplying goods.

The Committee recommended that suppliers delivering goods within the 15 days prior to bankruptcy or receivership be entitled to demand repossession for up to15 days after the triggering event. To protect suppliers during reorganization of a debtor corporation, the Committee recommended that the 15 day period before bankruptcy during which the supplier must demand repossession not expire during reorganization proceedings. The Committee also advised that more effective protection was needed for farmers and fishermen.

Parliament adopted the Committee's recommendations on protection in reorganizations and for farmers and fishermen, but not its recommendations on the timing provisions. The unpaid supplier provisions enacted in 1992 are essentially those in force today.

Unpaid supplier issues were considered again by the Bankruptcy and Insolvency Advisory Committee in its review of insolvency law issues during 1993/94. However, no clear evidence on the impact or effectiveness of the unpaid supplier provisions introduced in 1992 was available and no changes were recommended. No changes were made in the reform of the BIA in 1997 as well.

Supplier issues were discussed further in early 1999, at the National Insolvency Forum sessions organized by the Office of the Superintendent of Bankruptcy. The verdict on the existing measures was generally negative. The provisions were said to be ineffective and the protection provided often illusory. The ineffectiveness of the protection in reorganizations was noted, as was the lack of protection for service suppliers. It was claimed in one session at least that the provisions reduced credit availability, although their ineffectiveness presumably would dampen that impact.

Several solutions to the perceived problems were suggested in the National Insolvency Forum sessions, including: clarifying the requirements that goods be in the "same state" and "identifiable", calculating the eligibility period for repossession back from the date of

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[22]The House of Commons Standing Committee on Consumer and Corporate Affairs and Government Operations.

bankruptcy or receivership rather than forward from the delivery date, extending protection to service suppliers, withholding recognition of security on goods delivered within 90 days prior to bankruptcy, and making directors and officers liable for unpaid supplier claims. There was no strong leaning in favour of any one of these widely varying proposals.

<u>Assessment</u>

Fairness - Section 81.1 of the BIA attempts to protect unpaid suppliers as a vulnerable class of creditors who may lack the market power to protect themselves and who may ill afford losses on deliveries that have not been paid for. This section seeks to protect suppliers against any abuse from owners of a business stocking up on inventory just prior to a bankruptcy in order to provide a source of funds to cover their personal guarantees of the company's debts.

While the objectives are worthy, some apparently feel that the effectiveness of section 81.1 in protecting suppliers is problematic. Its coverage is arbitrary. Service suppliers are not covered at all. Goods suppliers lose any protection after 30 days from delivery or when the goods are no longer identifiable or in the same condition as when delivered.

Furthermore, the existing unpaid supplier legislation does not provide any effective protection in reorganizations. Suppliers are not allowed to repossess during reorganizations and in the meantime buyers can use or dispose of the goods during this process. Overall, indications are that s.81.1 has resulted in a relatively small amount of goods being repossessed by suppliers.

S.81.2 is much more effective than s.81.1 in protecting these same interests as it makes debts for goods purchased and delivered in the 15 days prior to bankruptcy/receivership a first priority on inventory. However, this applies only to farmers, fishermen and aquaculturists. Under this section, suppliers need not be concerned about whether the goods they have delivered are identifiable, in the same state, or have been resold. The timing constraints are also less onerous for these suppliers.

Efficiency - Section 81.1 imposes direct costs on bankruptcy administration. These direct costs include the costs of handling supplier demands, namely vetting claims, identifying goods as those delivered by the supplier, confirming that they are in the same state as when delivered, and verifying that they have not been resold.

Section 81.1 also intervenes in credit markets. Even if there seems to be limited chance for recovery, evidence suggests that lenders have made adjustments to their margining formulas to account for the possibility that suppliers may have prior claims to goods delivered within the 30 prior days. This appears to have occurred even though the tough conditions suppliers must meet to repossess goods may have kept the increase in risks faced by lenders small.

Overall, it is not clear to what extent s.81.1 has affected lending. Competition between lenders would also tend to limit the impact. To the extent that lenders have alternative lending opportunities, credit supply to buyers may be quite sensitive to supplier protection. In an increasingly globalized economy, these alternative lending options have increased and credit supply may become more sensitive to suppliers' rights.

There appears to be little evidence of any broad market failure in inventory financing. Suppliers have risk management tools available to them, including buyer monitoring and credit insurance. Where applicable, the *Personal Property Security Act* provisions for PMSIs offer a very effective means for suppliers to manage risk. However, there are some weak spots in inventory credit markets.

Smaller suppliers especially may lack the information required about their buyers to make informed credit decisions. This information often is more readily available to working capital lenders, who may be better positioned to monitor the strength of their debtor's financial position on an ongoing basis. Given this, providing working capital lenders with an incentive to monitor buyers may increase efficiency. It might help stimulate a weeding out of weaker businesses and prevent suppliers from taking on excessive risk.

Another advantage of S.81.1 is that it might help reduce any incentive for principals of buyer companies to stock up in inventory prior to bankruptcy, thus reducing the scope for abuse of suppliers and promoting confidence in the credit system. Overall, s.81.1 may have both efficiency enhancing and efficiency reducing effects.

S.81.2 intervenes more forcefully in credit markets than does s.81.1 and could be expected to have a greater impact on efficiency. However, its scope is so limited as to make its overall effect on the economy negligible.

c) U.S. Regime

Features

The U.S. Bankruptcy Code does not have any specific rules which give priority to unpaid supplier claims. However, it recognizes state laws which give unpaid suppliers the right to reclaim goods delivered provided the buyer was insolvent when they were delivered and the demand for repossession is made within ten days of delivery, or within 20 days if the initial ten days expired after bankruptcy proceedings started.[23] (See Table "D") The right to repossess lapses once the buyer is no longer in possession of the goods and it cannot be exercised against a good faith buyer or a buyer in the ordinary course of business. Further, the right is subject to any security interest having priority under state law.

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[23]S.2-207 of the *Uniform Commercial Code*, which has been adopted by all states, enables a supplier to reclaim goods from an insolvent buyer. Most provinces do not have supplier rights laws, so the U.S. regime could be most readily adopted in Canada by establishing a federal unpaid supplier right, subject to the same limitations.

The Code allows the court to substitute lien protection or preferred creditor status for supplier claims in place of the right to reclaim. Similar protection is given to unpaid claims for the supply of grain or fish.

Assessment

Fairness - Suppliers in the United States face problems in the repossession of goods which are similar to those experienced by Canadian suppliers. The ability of a supplier to enforce its' rights depends upon it being able to identify goods as its own, on the goods being in the buyer's possession and on their not being resold. While U.S. rules do not present the same timing problems as do the Canadian rules, they are quite tight.

Another important consideration is that in making suppliers' rights subject to private sector security interests, the U.S. rules offer less protection than exists in the Canadian rules. On the other hand, supplier rights in the United States apply in reorganizations. This avoids an important gap in protection which is currently found in Canada.

Efficiency - Since state laws which give private sector security priority over suppliers' rights are recognized in bankruptcy, lenders in those states who take security on inventory do not have an incentive to tighten their margin formulas. The effect in the marketplace of the U.S. regime is less than that of the Canadian regime for normal bankruptcies. However, the recognition of unpaid supplier repossession rights in reorganizations limits the ability of debtors to reorganize under the U.S. model. This is somewhat reduced by the provision for substituting liens or preferred creditor status for repossession, which may enable reorganizing debtors to retain essential supplies.

d) Alternative Models for Unpaid Supplier Claims

1. Extend the Repossession Right and Adjust the Timing

Features

One alternative available to the existing Canadian regime would be to extend the repossession rights for unpaid suppliers to encompass reorganizations and to adjust the timing limitations for making a claim. Under this model, the current Canadian regime would be left as is except for two changes to s.81.1. The first change would be to expand the scope of s.81.1 by establishing the repossession right upon the start of reorganization proceedings under either the BIA or CCAA. The second change would be to replace the requirement to demand repossession within 30 days of delivery, by a requirement that delivery have occurred within 15 days before bankruptcy, receivership or start of a reorganization and that demand for repossession be made within the 30 days after the event.

Assessment

Fairness - The proposed change to the time periods would increase supplier recoveries by expanding the period for demanding repossession. In reorganizations, the change would increase protection for suppliers by enabling them to repossess as soon as reorganization proceedings start. This change would curb the ability of buyers of goods to use reorganization provisions to defeat supplier rights.

Efficiency - The proposed model would have more impact on marketplace activity than the current regime. By increasing the protection for suppliers the risk would increase for lenders. The changes would also intervene in credit markets where they would reduce the options available to market participants and increase the cost of capital. It also would reduce the scope for reorganizations, possibly substantially, as the exercise of suppliers' rights could deprive reorganizing debtors of inventory.

2. Make Directors and Officers Personally Liable for Stocking Up

Features

The principals of smaller companies are often required to personally guarantee the company's debts. If the company becomes insolvent, those principals have a strong incentive to get the company to stock up on inventory in order to cover those debts and reduce their personal exposure. A direct way of addressing the stocking up problem might be to make directors and officers of a company liable for the value of unpaid goods and services bought within 90 days prior to the start of bankruptcy or reorganization proceedings under the BIA or CCAA, unless the purchases could be shown to be in the ordinary course of business. A due diligence defence would be provided. Such a measure would replace both s.81.1 and s.81.2.

Assessment

Fairness - This model would provide protection to suppliers, although the protection would be less comprehensive than a supplier protection regime with a general application. It would, however, increase the risk and potential defence costs for all directors, including innocent directors.

Efficiency - This regime would not intervene in credit markets and would have less impact on credit availability. It would also avoid the administrative problems of a repossession rights regime. However, it would require insolvency administrators and possibly the courts to determine whether purchases are in the ordinary course of business. In addition, it would add to the directors' liability burden borne by directors of all corporations, including large public corporations. This can have the affect of further reducing the willingness of qualified individuals to serve as directors, an issue that has already been noted as an increasing problem by corporate Canada.

3. Statutory Charges on the Current Assets of the Buyer

Features

This model would give unpaid suppliers statutory security interests over the cash, liquid securities, accounts receivable and inventory of their purchasers. The charge would replace the current repossession rights in the BIA. It could cover goods and services delivered within 15 days prior to the bankruptcy, receivership or start of BIA or CCAA reorganization proceedings. It would rank behind PMSIs and builders' liens, but ahead of other security interests. A buyer in good faith would be exempt from the charge. To maintain the charge, suppliers would have to notify the trustee, receiver or CCAA monitor within 30 days of the commencement of the proceedings.

Assessment

Fairness - This model would provide quite effective and comprehensive protection to suppliers in insolvencies. Protection would be more certain than under s.81.1, as suppliers would not have to meet s.81.1 timing and eligibility conditions. However, lender adjustments leading to new credit terms and purchasing arrangements would offset supplier benefits to some extent.

Efficiency - The application of statutory security interests over the current assets of the buyer would intervene more forcefully in both credit and goods and services markets than s.81.1. It also would impose new risks on other creditors, redistribute significant value from the other creditors to suppliers in bankruptcies and reorganizations and could have a substantial effect on lender behaviour. The availability of credit could be reduced, particularly for firms whose purchases are not now amenable to s.81.1 repossession and for purchasers of services. Lending rates for purchasers could rise, although in a borrowers' market, where competition between lenders is keen, the impact would not be that substantive. Non-bank lenders might be ready to take on more inventory lending - merchant banks have been mentioned in that regard. However, all potential lenders would be affected by the shift in risks this model would entail.

This model would make reorganizations more difficult, as any reorganization proposal would have to take into account the higher priority status of supplier claims. Given that there is little evidence of market failures in inventory credit markets, it seems likely that this regime would distort market activity and thus reduce efficiency. On the other hand, this regime should impose lower administration costs than the s.81.1 regime.

4. Statutory Charge on all Assets of the Buyer [24]

Features

The essential elements of this model are similar to those of the previous model, except that here the charge would apply to all assets of the debtor, not just to current assets.

Assessment

Fairness - Making all the assets of a purchaser subject to the charge would increase returns to suppliers in insolvency proceedings. However, it may be debatable whether longer-term lenders, with no day to day involvement with the purchaser, or ability to monitor the purchaser's affairs, should have their claims subordinated to those of suppliers.

Efficiency - This model would intervene even more deeply in credit markets than the current assets charge model. It would impact on longer term fixed lenders, increasing their risks and distorting market pricing in longer term lending. These lenders would have less ability to monitor purchaser risk than short term, current asset lenders, so the distortions produced by the statutory charge would be correspondingly greater. Overall, this regime would likely be more efficiency reducing than would the current assets charge model.

5. Statutory Charge Subject to Waiver

Features

Under this model, a statutory charge on either current assets or all assets would be adopted, but the BIA and CCAA would explicitly recognize agreements by suppliers to waive their priority in favour of lenders.[25]

Assessment

Fairness - By explicitly letting market forces operate and allowing the market power of lenders to be brought to bear, this model could result in less protection for suppliers in insolvencies than the statutory charge without waiver models. The impact could likely be greatest upon smaller suppliers with little bargaining power.

Efficiency - This model would be less interventionist and would have less effect in shifting risks

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[24]This model is based on a proposal by Professor R. Cuming in a paper prepared for Industry Canada entitled "Priority for Unpaid Suppliers of Goods and Services in Bankruptcy, Insolvency, Winding-Up and Receivership Proceedings", June, 1998.

[25]Waiver negotiations would be driven by buyers of goods and services, whose incentive would be the prospect of getting better lending terms from their lenders by bringing their suppliers and lenders together.

to lenders and therefore less impact on credit availability than the non-waiver models. It would give credit markets more operating room while still providing the affected parties, including suppliers, buyers and lenders greater freedom to negotiate the risks they bear in accordance with their preferences. It would distort market pricing to a lesser extent. Overall, it should be more efficient than the non-waiver models.

6. No Special Protection for Suppliers in the BIA

Features

Under this model, there would be no repossession rights. Ss.81.1 and 81.2 would be repealed and not replaced.

Assessment

Fairness - The repeal of these sections would provide less protection to suppliers in bankruptcies and receiverships.

Efficiency - This model would remove the impact of the current BIA repossession rights. Risk would be shifted from lenders back to suppliers. Marketplace forces would be given full scope. Credit availability would likely increase. On the other hand, the effect of the current repossession rights in discouraging stocking up would be lost. Also, it would not help suppliers who cannot readily monitor buyers to avoid taking on excessive risks.

C. Conclusions

Unpaid supplier protection has been a lively bankruptcy reform issue since the 1970s. The 1992 amendments to the BIA addressed the issue by creating repossession rights which provide direct protection to suppliers in bankruptcy or receivership of their customers. However, the rights established in 1992 have been widely criticized as offering ineffective, if not illusory, protection. It has been pointed out that they are arbitrary in scope, provide no real protection in reorganizations and are costly to administrate.

In the United States, the U.S. Bankruptcy Code does not have any specific rules which give priority to unpaid supplier claims. However, it explicitly recognizes state laws which do so. Those rules operate in a fashion similar to those in Canada, although supplier rights to repossess continue to apply more effectively in reorganizations.

One option for improving the Canadian regime would be to extend the repossession rights for unpaid suppliers to encompass reorganizations and to adjust the timing limitations for making a claim. This would increase supplier recoveries but it would increase the risk to lenders and possibly the cost of borrowing funds. It also might reduce the scope for reorganizations as the exercise of suppliers' rights could deprive reorganizing debtors of inventory.

Another option is to make directors and officers personally liable for the value of unpaid goods and services bought within a certain number of days prior to bankruptcy or reorganization proceedings unless the purchases can be shown to be in the ordinary course of business. This option, however, increases the already much famed directors liability scare and defences and unnecessary court action or verification could significantly increase costs to directors and to the economic system.

A further set of options are statutory charges to the current assets or to all of the assets of the buyer. Statutory charges would avoid important defects in repossession rights by providing more effective protection to suppliers, applying to goods and services, protecting suppliers in reorganizations without depriving reorganizing debtors of essential materials, and being easier to administrate. However, they would be more interventionist and could reduce credit availability and marketplace efficiency.

APPENDICES

A. Wage and Pension Legislation

a) Canada

<u>Wages</u>

Preferred status

The *Bankruptcy and Insolvency Act* (BIA), s.136(1)(d), gives preferred status to up to $2,000 in claims for wages, salaries, commissions and compensation and to $1,000 for salespersons' disbursements. Coverage is limited to claims for services provided in the six months before bankruptcy. Wage claims rank fourth among preferred claims, behind funeral and testamentary expenses, costs of administration and the levy payable to the Superintendent of Bankruptcy. As preferred claims, wage claims rank ahead of those of ordinary creditors but behind those of secured creditors.

Some provinces give wage claims priority only over unsecured creditors of the employer. For example, s. 14 of the Ontario *Employment Standards Act* states that wages shall have priority over and be paid before the claims and rights of all other unsecured creditors of an employer, to the extent of $2,000 per employee. These provisions do not operate in bankruptcy, being superceded by s.136 of the BIA.

Statutory security interests

The federal *Bank Act* provides a form of security interest for wage claims, giving them priority over certain claims of a bank secured under that Act. S. 427(1)(b) of the *Bank Act* enables a bank to lend to a wide range of businesses, including wholesalers, retailers and shippers of forest, farm and mine products, manufacturers, farmers and fishermen, on the security of goods purchased, used, produced or sold by those types of businesses. Subs.427(7) gives priority over the bank's security to claims of employees of the borrower for wages earned within the three months before bankruptcy.

Some provinces have established statutory security interests to protect wage claims. These security interests have varying degrees of priority. Some give priority to wage claims over secured claims. For example, s. 38.1 of the New Brunswick *Employment Standards Act* provides for a lien in favour of the employee for wages owing where a certificate stating the amount of wages owing is filed by the director of labour standards. The lien is given priority over all other claims, including secured claims.[26] The Saskatchewan *Labour Standards Act*

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[26] It is not clear that a s.38.1 lien would take precedence over security interests established before the lien's filing.

provides a stronger security interest.[27] It deems wages owing to be secured by a security interest over the employer's property and gives the wage earners' claims priority over all other rights except those of PMSI holders and real property mortgage lenders. These provincial security interests do not operate in bankruptcy.

Deemed trusts

Deemed trusts are another device used by several provinces to give priority to wage claims. An example is s.14 of the Ontario *Employment Standards Act* which provides that an employer is deemed to hold vacation pay in trust for an employee whether or not it has been held separate and apart in fact. Deemed trusts covering wage claims have also been ruled inoperative in bankruptcies.

Directors' liability for wages

Wage earners are protected by provisions in federal and provincial corporations and employment standards legislation which impose personal liability on directors for unpaid wages of their corporations. For example, section 119 of the *Canada Business Corporations Act* makes directors of a corporation jointly and severally liable to employees of the corporation for all debts not exceeding six months wages for services performed for the corporation while they were its directors. Directors are not liable if they relied on financial statements of competent corporate officers or professional advisors.[28] Section 251.18 of the *Canada Labour Code* establishes that directors of a corporation are jointly and severally liable for wages and other amounts to which an employee is entitled, to a maximum amount equivalent to six months' wages, to the extent that the entitlement arose during the particular director's incumbency and that recovery of the amount from the corporation is impossible or unlikely. Here the liability is absolute: there is no defence. Provincial provisions are generally similar; some provide due diligence or good faith reliance defences, some impose absolute liability.[29]

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[27]S.56(1)-(1.3).

[28]CBCA, s.123(4).

[29]See section II of Industry Canada's paper *Efficiency and Fairness in Business Insolvencies* for a more complete description of provincial directors' liability for wages provisions.

Pensions

The BIA provides no direct protection for pension fund claims. Protection is provided in federal and provincial pensions legislation. The federal *Pension Benefits Standards Act* requires an employer to ensure that the money in the pension fund and all amounts deducted from workers' remuneration are kept separate and apart from the employer's own money and deems the employer to hold the amounts in trust.[30] It further provides that if the employer goes bankrupt, the amount deemed to be held in trust shall be deemed to be separate from the estate in bankruptcy, whether it is or not.[31]

In most provinces, legislation regulating pensions gives a pension fund a lien or charge against the employer's assets for amounts owed by the employer to the fund. For example, s. 40.2 of the Alberta *Employment Pension Plans Act* provides that money held by an employer for a member, former member or beneficiary of a pension plan is secured by a security interest on the property and assets of the employer to a maximum of $5,000 per employee whether or not that property or those assets are subject to other security interests.[32]

Some provincial pension statutes require money owing to a pension fund to be held in trust by the employer and deem the money to be held in trust whether it is or not. For instance, the Ontario *Pension Benefits Act* deems an employer who receives money from an employee intended as the employee's contribution under the pension plan to hold the money in trust for the employee until it is paid into the pension fund whether or not the funds have been kept separate and apart.[33] An employer is also deemed to hold its own contributions to a pension plan in trust and to keep these trust funds separate and apart from its other money or property.

Other forms of protection for pension fund claims at the provincial level include director's liability provisions in some provinces and, in Ontario, the "Guarantee Fund" out of which shortfalls in pension funds can be paid. The fund is given a lien against the assets of the employer responsible for the shortfall.

b) United States

Wages

S.507 of the U.S. *Bankruptcy Code* gives preferred status to claims up to $4,300 in total for wages, salaries and commissions, including vacation, severance and sick leave pay, as well as

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[30]PBSA, s.8.

[31]Subs.8(2).

[32]S.40.2.

[33]S.57.

sales commissions, earned within 90 days before bankruptcy.[34] The Code does not establish liens or security interests protecting wage claims, but does recognize state liens. A few states have established such liens. To be recognized, the following two conditions set out in section 545 of the Code must be met:

1. The state security interest must not take effect only upon insolvency or a judgement enforcement measure.

2. A state-created lien must be enforceable on the date of the filing of the bankruptcy against a purchaser of the property.

<u>Pensions</u>

S.507 of the Code also gives preferred status to claims for contributions to an employee benefit plan arising from services provided within the six months before bankruptcy, to a maximum of $4,300 per employee covered by the plan. The aggregate amount covered is reduced by the amount paid to employees for wages under s.507. Where employees are covered by more than one plan, the coverage is limited to $4,300 per employee for all plans in aggregate.

B. Unpaid Suppliers Legislation

a) Canada

<u>BIA provisions</u>

Section 81.1 enables a supplier of goods to a buyer who is bankrupt or in receivership to demand repossession of the goods within 30 days of delivery. The supplier may repossess goods delivered if at the time it makes its demand the goods are in the possession of the buyer, trustee in bankruptcy or receiver, are identifiable as the goods delivered by the supplier, are in the same state as when delivered and have not been resold. The right to repossess has priority over all other claims to the goods "...other than the right of a bona fide subsequent purchaser of the goods for value without notice that the supplier had demanded repossession of the goods.".[35] Where the buyer has made a partial payment, the supplier may repossess the unpaid for portion or return the buyer the money paid and repossess all the goods supplied.

S.81.2 gives suppliers of farm, fish or aquaculture produce delivered within 15 days before the buyer's bankruptcy or receivership a charge against the inventory of the buyer at the date of bankruptcy or appointment of a receiver. To maintain the charge, the supplier must file a claim with the trustee or receiver within 30 days after the bankruptcy or receivership. The charge covers the proceeds of sale of the goods, net of costs of realization. The charge ranks

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[34]Wage claims rank third, behind administrative expenses and fees of trustees and claims of creditors arising in the ordinary course of business in an involuntary case before the debtor has been declared bankrupt.

[35] S. 81.1(6), BIA

ahead of all other claims to the inventory save those of a supplier under s.81.1.

Article 1741, Quebec *Civil Code*

Article 1741 enables an unpaid supplier of goods to rescind the sale and repossess the goods if they are in the same condition as when delivered and have not been sold. The supplier must elect to repossess within 30 days of delivery. Article 1741 does not apply to sales on credit.

Statutory Security Interests

Bank Act

S.427 enables a bank to lend money to manufacturers on the security of the goods manufactured and on goods bought by a manufacturer as inputs.[36] S.427 gives priority over the bank's security under the section to the claims of a supplier of agricultural produce to a manufacturer in respect of goods supplied within six months before the manufacturer's bankruptcy.[37] However, there is a ceiling on the amount of a supplier's claim given priority, calculated according to a formula tied to the price index of farm produce.[38]

Builder's liens

Provincial builder's liens legislation gives persons who supply goods to or perform services on a building site a lien against the site owner's interest in the site. The owner is required to hold back a portion of the building contract price for a specified time and, if a lien is filed within that time, to hold back an amount sufficient to pay the lien. The lien is a charge again the hold back amount. It has priority over a mortgage to the extent of payments made by the mortgagee after receiving notice of the lien, or after the lien is registered.

Repairer's liens

Provincial legislation gives repairers and storers of property a lien on the goods repaired or stored. These liens may be registered and have priority over other claims to the goods.

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[36]S.427(1)(b).

[37]S.437(7).

[38]S.427(8).

b) United States

S.2-702 of the *Uniform Commercial Code* (UCC), which has been adopted in all U.S. states, provides that an unpaid supplier of goods to an insolvent debtor can reclaim the goods upon demand made within 10 days of delivery. The 10 day limit does not apply if the debtor concealed its insolvency. The right to reclaim is also "...subject to the rights of a buyer in ordinary course or other good faith purchaser...".[39]

S.546(c) of the *Bankruptcy Code* recognizes statutory and common law rights of a supplier to reclaim goods supplied in the ordinary course of business. The demand must be made within 10 days of delivery, or within 20 days if the 10 days expires after bankruptcy occurs. Hence, the *Code* effectively preserves s.2-702 of the UCC in bankruptcy. The court may substitute a lien in favour of the supplier for the right to reclaim. The right to reclaim is conditional on the goods being in the possession of the debtor.

S.546(d) of the *Code* recognizes statutory or common law rights given to grain producers and fishermen to reclaim grain or fish delivered to an insolvent grain or fish storage facility. The demand must be made within 10 days. The court may substitute a lien for the right to reclaim.

[39]Section 2-702, United States Uniform Commercial Code

TABLE "A"

Wage and Pension Claim Protection in Canada

	Statutory Preference	Security Interests/ Liens	Deemed Trusts	Director's Liability	Other Protection
FEDERAL	<u>Wage Claims</u> Claims for wages earned within 6 months before bankruptcy, up to $2,000 plus salespersons' disbursements up to $1,000 rank fourth among preferred claims. S. 136(1)(d), *Bankruptcy and Insolvency Act* (BIA) . <u>Pension Claims</u> N\A	<u>Wage Claims</u> Claims for wages earned within three months before bankruptcy have priority over a bank's security under s.427 of the *Bank Act.* If the bank takes possession of the encumbered property, it is liable for wage claims to the extent of the net amount realized. <u>Pension Claims</u> N\A	<u>Wage Claims</u> N/A <u>Pension Claims</u> Employers are required to hold money due to a pension fund in trust and these amounts are deemed to be held in trust in case of bankruptcy. S. 8(1), Pension Benefits Standards Act (PBSA)	<u>Wage Claims</u> Directors are liable for debts not exceeding 6 month's wages, under s. 119 of the *Canada Business Corporations Act*. Directors are liable for wages, termination and severance pay to an amount equivalent to 6 month's wages, under s. 251.18 of the *Canada Labour Code*. <u>Pension Claims</u> N\A	<u>Wage Claims</u> N/A <u>Pension Claims</u> N\A

	Statutory Preference	Security Interests/ Liens	Deemed Trusts	Director's Liability	Other Protection
P R O V I N C I A L	<u>Wage Claims</u> Several provinces give wage claims priority over other creditors. In bankruptcy, s. 136, BIA applies. Eg. In Ontario, an employee is given priority for wage claims over all other creditors , up to $2,000. S. 14, *Employment Standards Act* <u>Pension Claims</u> N\A	<u>Wage Claims</u> Many provinces provide wage claims with security interests over the debtor's assets. However, s. 136, BIA applies in bankruptcy. Eg. In New Brunswick, a public official may issue a certificate stating the amount of wages owed which, when registered, constitutes a lien in favour of the worker over other claims in the property. S. 38.1, *Employment Standards Act* <u>Pension Claims</u> In most provinces, pension legislation gives a pension fund a lien or charge against the employer's assets. Eg. In Alberta, a lien is given on assets of the employer, up to $5,000. S. 40.2, *Employment Pension Benefits Act*	<u>Wage Claims</u> Several provinces have deemed trusts to protect wage claims. However, s. 136, BIA applies in bankruptcy. Eg. In Manitoba, an employer is deemed to hold the wages due to a worker in trust for that worker and the employee has a liens on the assets of the employer for the amount held in trust. S. 53, *Payment Wages Act* <u>Pension Claims</u> Some provincial statutes require moneys owing to a pension fund to be held in trust by the employer and deem them to be held in trust whether they are or not. Eg. In Nova Scotia, employers have a duty to hold moneys due to the pension fund in trust. S. 46, *Pension Plans Act*	<u>Wage Claims</u> Many provinces hold directors liable for unpaid wages of workers under corporations and employment standards legislation. Eg. In British Columbia, a director is liable for unpaid wages for an amount equivalent to 2 months' wages for each employee. S. 96, *Employment Standards Act* <u>Pension Claims</u> In some provinces, pension funds are protected through director's liability. Eg. In Quebec, directors are liable for unpaid contributions to pension plans. S. 227, *Supplemental Pension Plans Act*	<u>Wage Claims</u> A public official may investigate a claim of unpaid wages and order the payment of the amount by the employer. Eg. In Saskatchewan, employees may file complaints with the director of employment standards who may issue a payment order. S.68.4, *Labour Standards Act* Wage earner protection funds were established or proposed in Ontario, Manitoba and Quebec. None of those funds are in force. <u>Pension Claims</u> In Ontario, the Pension Benefits Act provides funded protection. The fund is given a lien.

TABLE "B"

Wage and Pension Claim Protection in the United States

	Statutory Preference	**Security Interests/Liens**	**Deemed Trusts**	**Emplo-yer's Liability**	**Other Protec-tion**
FEDERAL	Wage Claims Claims for salaries (including vacation, severance and sick leave) earned within 90 days before bankruptcy, up to $4,300, rank third among preferred claims, as per §507, *Bankruptcy Code* (Title 11, USC). Pension Claims The *Bankruptcy Code* gives preferred status to claims up to $4,300 for pension claims for contributions to worker benefit plans arising from services rendered within 6 months before bankruptcy, ranking them fourth. §507, *Bankruptcy Code*	Wage Claims N\A. Pension Claims N\A	Wage Claims N\A. Pension Claims N\A	Wage Claims N\A. Pension Claims N\A	Wage Claims N\A Pension Claims N\A.
STATE	Wage Claims N\A. Pension Claims N\A	Wage Claims State security interests covering wage claims, including those giving priority over other security interests are recognized in bankruptcy if the requirements set out at s. 545, *Bankruptcy Code*, are met. The requirements are: 1. state security interests must not take effect only upon insolvency or a judgement enforcement measure 2. state-created liens must be enforceable on the date of the filing of the bankruptcy against a purchaser of property. Pension Claims N\A	Wage Claims N\A. Pension Claims N\A	Wage Claims N\A Pension Claims N\A.	Wage Claims N\A Pension Claims N\A

TABLE “C”

Claims for Unpaid Suppliers in Canada

	Repossession	**Security Interests/Liens**
FEDERAL	Unpaid suppliers of goods, under s. 81.1, BIA, have the right to repossess goods from a buyer who is a bankrupt provided that : • the supplier presents a written demand for repossession within 30 days of delivery • the goods are identifiable and in the same state as when delivered • the goods have not been resold	Suppliers of agricultural, fish and aquicultural produce have a charge against the inventory of the buyer for the value of the produce delivered within 15 days prior to bankruptcy, as per s. 81.2 BIA. The charge ranks above every other claim against that inventory, except inventory subject to a claim under s. 81.1 BIA. S. 427, *Bank Act* gives claims of growers of agricultural products for the value of products supplied to a manufacturer within 6 months before bankruptcy priority over a bank’s s.427 security interest.
PROVINCIAL	Under s. 1741,*Quebec Civil Code*, in the sale of a moveable property the seller may resolve the sale and claim (“revendiquer”) the property, within 30 days of delivery, if : • the buyer has failed to pay the price of the good • the property remains in its entirety • the good is in the same condition as when it was delivered • the good has not passed into the hands of another buyer	Suppliers of goods or services to a constructions site have a lien against the site for the value of goods and services supplied. Repairers and those who store personal property also have a lien against the property. Common law gives suppliers of goods and services liens to secure the price of the materials or services supplied, providing that the supplier has retained possession of the goods subject to the lien. Sellers of goods can take purchase money security interests in the goods supplied which covers the proceeds of the sale of the goods and has priority over competing security.

TABLE "D"

Claims for Unpaid Suppliers in the United States

	Repossession	**Security Interests/Liens**
FEDERAL	S. 546(c), *Bankruptcy Code* recognizes rights under state law and common law rights of the seller who in the ordinary course of business has sold goods to the debtor, to reclaim those goods within ten days of delivery, provided that the goods are in possession of the buyer. If the ten day period expires after the invocation of bankruptcy, it is extended to 20 days. The right of reclamation is subject to any security interest in the goods that has priority under state law S. 546(d)of the *Bankruptcy Code* recognizes the statutory or common law right of reclamation exercise within 10 days of delivery by : • producers of grain sold in the seller's ordinary course of business with a grain storage facility owned or operated by the debtor • fishers who have sold fish in the ordinary course of business to a fish processing facility owned or operated by the debtor	N/A
STATE	When an unpaid seller of goods discovers that the buyer was insolvent at the time of delivery of the goods, the seller may reclaim the goods upon demand made within 10 days after delivery of the goods to the buyer. S. 2-702 of the *Uniform Commercial Code*.	N/A