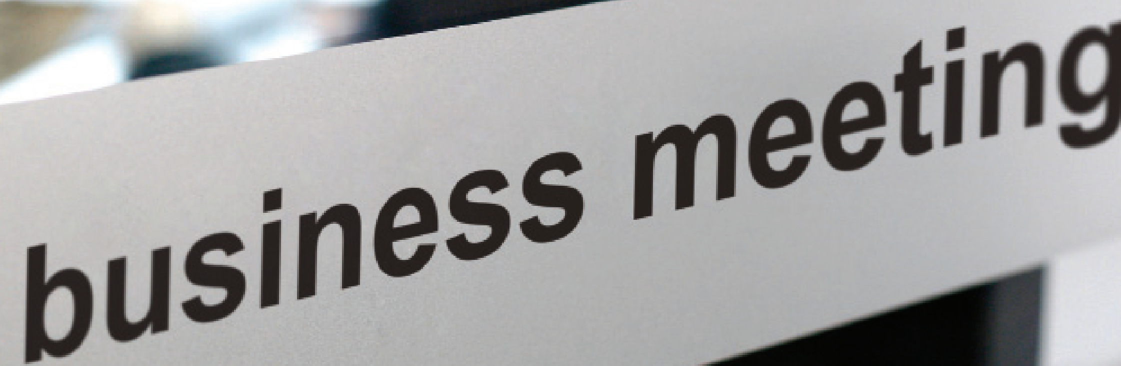


# WHEN A BUSINESS FAILS

No one ever starts a business with the expectation that it will someday fail. Nonetheless, businesses can and do fail all the time, and whether the cause is poor planning, poor timing, or just sheer bad luck, the options available to the business owner are generally the same.

BERGER CAVAN GROUP
Chartered Professional Accountants and Business Advisors
202 - 2022 Cornwall Street • Regina, SK • S4P 2K5

It's sometimes thought that when a business is in significant financial difficulty the only choice available to the business owner is going bankrupt, a result that almost no one wants. But while it's true that bankruptcy is one of the available options, it's not the only one. In fact, bankruptcy is, in many ways, the last option—one to be resorted to only when all other choices are either not available or have been tried unsuccessfully.

Most of the rules governing the options open to business owners who are in financial difficulty are federal rules—meaning that they apply across Canada, in all provinces and territories. This article summarizes the options open to those in financial difficulty who are operating a business as a sole proprietorship or in a partnership, the required procedures which accompany each option, and the effect of each on the continued operation of the business.

## First steps

Often, the first sign that a business is in financial difficulty is that cash flow problems have arisen; the money just isn't there to pay suppliers' invoices, or maybe even employee wages, as they fall due. A cash flow crunch can arise for any number of reasons—revenues may be down, owing to a drop in sales, the business may have incurred an unexpected large expense, or the business may itself be waiting for payment of a large invoice which it has issued.

The best short-term solution to such cash flow problems depends on the cause. Where the business is temporarily short of funds because it is owed money that it expects to receive soon, taking out a short term loan or, more usually, accessing the business's line of credit is probably the best solution. The same strategy can be used where cash flow problems are caused by a (hopefully) temporary slowdown in sales, but in that case, the risk is greater, as the ability to repay the increased debt will depend entirely on generating higher than usual sales over the next few weeks or months. Where a business already has a number of overdue debts outstanding, the business owner can also consider a consolidation loan, which will allow him or her to pay off those debts and then to make a single payment each month on the consolidation loan. Often, consolidation loans can be obtained at a lower rate of interest than is usually applied to overdue commercial invoices.

Unfortunately, when a business is encountering financial difficulties, business owners sometimes turn to employee remittances as a source of ready cash. Employers must withhold from their employees' paycheques, and remit to the federal government, amounts for income tax, Canada Pension Plan (CPP) contributions and Employment Insurance (EI) premiums, together with employer contributions in respect of CPP and EI. Depending on how many employees the business has, and often those remittances must be paid, there can be a significant sum of money on hand, and more than one business owner has succumbed to the temptation to "borrow" that money to "temporarily" ease a cash flow crunch, fully intending to replace it when things improve. Unfortunately, in almost all cases, the only thing that the business owner is borrowing is trouble. The Canada Revenue Agency (CRA) is quick to follow up where such remittances are not made in full, on a timely basis, and the Agency has wide powers of enforcement at its disposal. As well, where money is owed to the CRA, the interest rate charged is, by law, well in excess of current commercial rates. For any number of reasons, unauthorized "borrowing" from the CRA is a bad idea.

Finally, where there are temporary cash flow problems, a business owner can approach his or her suppliers and other creditors and ask for more lenient or favourable payment or repayment terms, or even forgiveness of outstanding amounts. There's a risk to this approach—if suppliers become aware that a business is in any kind of financial trouble, they may not only refuse to provide more lenient payment terms for outstanding invoices, but may also refuse to provide future deliveries on anything other than a cash-on-delivery basis. But, where there is a long-standing personal or business relationship with a supplier or other creditor, such a strategy may be workable. It's really a judgment call on the part of the business owner, who will have to determine whether such an approach is advisable on a case-by-case basis.

Sometimes no amount of temporary relief or short-term juggling of obligations is sufficient to keep business debts from mounting with no realistic prospect of improvement in sight. Most often, this occurs where the business just can't seem to

generate the amount of revenue that was anticipated and is needed to cover expenses, or there are ongoing costs which continue to increase and which are simply not under the control of a business owner. Interest costs are one good example. Virtually all businesses owe money to someone, and many businesses go under when interest rates become so punitive—as in the early 1990s and, especially, the early 1980s—that it is just not possible to both service those debts and meet the business's other ongoing cash flow requirements. At this point, many business owners begin to wonder if bankruptcy is inevitable.

The short answer is that it is not. Even where the business owner has to concede that things cannot continue as they are, options still exist. The first of those options is the making of a proposal.

## Making a proposal

The making of a proposal is a formal procedure which is governed by the federal bankruptcy legislation, but there are at least two important differences between making a proposal and declaring bankruptcy. The first is that, with a proposal, the business owner/debtor retains ownership of all his or her assets and the second is that the making of a successful proposal allows the business to continue to operate and, hopefully, to return to a solid financial footing.

A proposal is, as the name would imply, an offer made to creditors to agree to a plan under which each creditor would accept less than the full amount owed, or would agree to be paid over a longer period of time than was originally planned, or a combination of both. While creditors obviously don't like having to accept less than the full amount they are owed, or having to wait for their money, the benefit to them is that they will at least recover something, and often more than they would receive in a bankruptcy. The debtor benefits by being able to retain ownership and control of his or her assets. Equally important, where a debtor makes a proposal which is accepted by his or her creditors, collection or enforcement actions which may already have been initiated by creditors are generally stopped. The exception to that rule is creditors to whom the debtor owes debts which would not be extinguished by a bankruptcy (as outlined below) —such creditors may, in most cases, continue their collection efforts. But with respect to most debts, making a successful proposal gives the business owner/debtor some breathing room to try returning the business to a profitable or at least a break-even position.

Canadian bankruptcy legislation sanctions two types of proposals, which are known formally as Division 1 proposals and Division 2 (or consumer) proposals. The latter is a more simplified

and streamlined process, which is available to individuals who owe less than $250,000, excluding any debt, like a mortgage or home equity line of credit, which is secured by the debtor's home. The Division 1 proposal process is available to both individuals and businesses, regardless of the amount or type of debt, but the procedures involved are more complex and the consequences to the debtor, should the proposal not be successful, are more significant and far-reaching.

### *Making a Division 1 proposal*

A business owner who wishes to make a Division 1 proposal must first contact a licensed trustee in bankruptcy, who will file a notice of intention to file a proposal with the Office of the Superintendant of Bankruptcy. Once that notice is filed, any collection actions which creditors may have already initiated are stopped, subject to the exception noted above. A copy of the notice of intention to file is provided to all creditors, and the debtor has thirty days within which to file the actual proposal.

Once the proposal is filed and made available to the creditors, the trustee in bankruptcy will set up a meeting of creditors, and at that meeting the creditors will vote to accept or reject the proposal made. Prior to the vote being taken, the trustee in bankruptcy must provide creditors with an estimate of how the amount they are being offered under the proposal compares to what they would recover on an actual bankruptcy.

If creditors representing at least two-thirds of the amount of debt outstanding and at least 50 percent plus one of the number of creditors vote in favour of the proposal, then the proposal is considered, subject to approval by the Court, to be accepted and to be binding on all unsecured creditors of the debtor. However, if the proposal is not accepted by the creditors then the debtor is automatically, as of the date of the creditors' meeting, put into bankruptcy.

Assuming that the proposal is approved by the creditors, then the debtor becomes responsible for making payments to the trustee in bankruptcy in the amounts and in accordance with the schedule set out in that proposal. If the terms of the proposal are adhered to, and payments to secured creditors are also kept current, the debtor remains in possession of all of his assets.

### *Making a Division 2 (consumer) proposal*

Individuals also have the option of making what is known as a Division 2, or consumer proposal. In many cases, this option might not be available to a business owner, since it requires the debtor to have less than $250,000 in outstanding debts (not included any debts secured by the debtor's home) and the debt load carried by all but the smallest businesses would likely exceed that threshold. Where, however, a consumer proposal is possible, it offers some fairly significant advantages to the debtor.

Like a Division 1 proposal, a consumer proposal must be made through a trustee in bankruptcy, who will file the proposal with the Office of the Superintendant of Bankruptcy and will also provide a copy of the proposal to creditors. The creditors then have 45 days in which to accept or reject the proposal. Within that 45-day period, any creditor or group of creditors who represent at least 25% of the outstanding debt can request that a meeting of creditors be held and, once the request is made, that meeting must take place within 21 days. At the meeting, a vote of creditors is taken and, if creditors representing a majority of the dollar value of the outstanding debt vote in favour, then the proposal is accepted. For example, if the claims against the debtor total $100,000, and the creditors voting in favour of the proposal represent $50,001 or more of those claims, then the proposal has been approved and is binding on all unsecured creditors, even if they voted against it. If there is no creditor or group of creditors that requests, within the 45-day period, that a meeting be held, then the proposal is considered accepted and is binding on all creditors, regardless of any objections.

Where the proposal is accepted, whether automatically or as a result of a vote of creditors, the results are the same. The debtor must make payments to the trustee in bankruptcy in the amount required and in accordance with the schedule outlined in the proposal. Assuming that the payments are made to the trustee and that any required payments are made to secured creditors, the debtor will remain in possession of his or her assets. He or she will also be required to attend two financial counseling sessions.

There is one other significant difference between Division 1 and Division 2 (consumer) proposals which are not accepted by creditors.

Where a Division 1 proposal is not accepted, the debtor is automatically put into bankruptcy. Such is not the case with a Division 2 proposal. Where such a proposal is rejected by creditors, there is no immediate consequence to the debtor. He or she is free to amend and re-submit the proposal to creditors, to declare bankruptcy, or to pursue any other available option to solve his or her financial difficulties.

## Declaring bankruptcy

Sometimes, despite the best efforts of the business owner, bankruptcy becomes the only available option. Perhaps the Division1 proposal put forward by the business owner is rejected by creditors, automatically putting that business owner into bankruptcy. Or, where a successful proposal is made, business results don't improve and the business owner just can't keep up with the payments required under the terms of that proposal. In some cases a business owner just can't foresee that there will be any improvement in business conditions or results and wishes to simply accept the fact that the business has failed and move on.

Even when things reach this point, bankruptcy can come about in a number of ways. If the debtor has made a Division 1 proposal which was rejected by creditors or has failed to adhere to the terms of a proposal which was approved by creditors, then what occurs is a "deemed bankruptcy"—in other words, the bankruptcy is automatic where either of those two events take place. Or a creditor or creditors of the business owner can file a petition with the Court for what is known as a receiving order against the debtor's assets, the effect of which is that the debtor has made what is termed an "involuntary assignment" in bankruptcy. Finally, the debtor can take the initiative and make a "voluntary assignment" in bankruptcy—in effect, making the choice to declare bankruptcy.

Whatever the method by which the debtor enters into bankruptcy, the process that follows is the same. The debtor must sign an "Assignment" transferring all of his or her assets to the trustee in bankruptcy. As well, a "Statement of Affairs" listing all of the debtor's assets, liabilities, income and expenses must be prepared and signed by the debtor. There may or may not be a meeting of creditors, but all of the known creditors will receive notice of the bankruptcy. Once all of the debtor's assets have been turned over to the trustee in bankruptcy, the trustee will sell the assets and distribute the proceeds among the unsecured creditors. The creditors are not allowed, once bankruptcy has been declared, to pursue any other means of recovering amounts from the debtor.

There are some assets which may be kept by the bankrupt and are therefore not transferred to the trustee in bankruptcy to be sold to satisfy creditors' claims. The specific assets that may be retained by the bankrupt can vary by province, and numerous exceptions and qualifications apply. Nonetheless, it is generally the case that the bankrupt can retain personal effects, like clothing and household furniture, a vehicle (up to a certain dollar value) and, what is likely of most importance to small business owners, amounts saved in a registered retirement savings plan (RRSP). The exemption for RRSPs may not apply to funds placed in the plan within a specified period before bankruptcy was declared.

Similarly, while bankruptcy generally operates to wipe out the existing debts of the bankrupt, some debts survive bankruptcy. Specifically, the bankrupt will continue to owe any outstanding alimony and child support amounts, any student loans (if the bankrupt graduated or left school less than seven years before declaring bankruptcy), any fines or penalties which had been imposed by a court, and any debts which arose from fraud.

After declaring bankruptcy, the bankrupt is allowed to work and earn income: however, if income exceeds an amount which is required to maintain a reasonable standard of living (known as surplus income), that surplus income must be given to the trustee in bankruptcy who will use it, in the same manner as the bankrupt's other assets, to satisfy the claims of unsecured creditors.

The bankruptcy process ends with the discharge of the bankrupt. Where an individual is bankrupt for the first time, that discharge takes place automatically nine months after the date of bankruptcy, if the bankrupt has no surplus income. Where there is surplus income, the automatic discharge comes twenty-one months after the date of bankruptcy. The period of time between the date of bankruptcy and the discharge date will be longer if there was a previous bankruptcy or if the bankrupt owes significant personal income tax amounts.

Finally, when a bankrupt receives a discharge from bankruptcy, the court may impose terms. An absolute discharge means that all debts incurred prior to the bankruptcy (subject to the exceptions outlined above) are wiped out. Where a conditional discharge is allowed, it means that the court has imposed conditions which the bankrupt must continue to meet (such as the payment of an additional amount to the trustee for distribution to creditors) before the discharge can become absolute.

## The effects of declaring bankruptcy

There's no question but that a declaration of bankruptcy is a significant legal and financial step and the effects of taking that step can last for a while. A person contemplating a declaration of bankruptcy often wonders about the effect that declaration will have on his or her credit rating and ability to borrow in the future. It's true that a person who has declared bankruptcy is usually placed in the lowest possible (i.e. highest risk) category for credit rating purposes and that will, of course, make borrowing much more difficult. However, the practical reality is that a person who has reached the point of contemplating a declaration of bankruptcy is already heavily in debt and likely in arrears on some or all of that debt. As a result, it's likely that the person's credit rating is already such that obtaining new credit would be difficult, or at least very expensive.

Those considering bankruptcy also wonder about the effect their bankruptcy might have on others, especially those who have guaranteed a debt or co-signed a loan for the bankrupt. The short answer is that the bankruptcy of an individual doesn't cancel any obligations which have already been assumed by guarantors or co-signers. Such guarantors or co-signers remain responsible for the debt even if the individual for whom they provided the guarantee or with whom they co-signed for the loan goes bankrupt—a bankruptcy affects only the obligations of the person who is bankrupt.

Finally, business owners often want to know what will happen to the business, in a legal sense, if they declare bankruptcy. The answer to that question depends on the type of business it was. If the business was being run as a sole proprietorship, then the business ends as of the date of the assignment in bankruptcy. If the business owner wishes to continue running a business (whether in the same or a different industry) the new business is entirely separate and distinct from the old one which has ceased to exist. The business owner will have to take all the steps needed to set up a new business, including obtaining a new business number from the CRA. If the old business was being operated as a partnership and there were only two partners, then the partnership comes to an end with the bankruptcy of either partner. Where, however, there are three or more partners in the partnership, the partnership can continue to operate even where one of those partners declares bankruptcy. As well, the partnership is not liable for any debts of the bankrupt partner.

## Conclusion

No business owner wants to have to give up on a business into which much time, money and effort has been put, or to publicly acknowledge that the business has in fact failed. And a declaration of bankruptcy—even where the failure was caused by unforeseen personal circumstances (like a serious illness or family breakup) or by economic conditions that make business success almost impossible—carries with it at some level a sense of personal failure.

Notwithstanding, the reality is that where personal or general economic conditions are such that no amount of effort will lead to success, there's really nothing to be gained from putting off the inevitable. Acknowledging the reality of the situation and seeking professional advice to determine the best course of action will enable the business owner to address the consequences of that business failure and, eventually, to move forward with a clean slate.