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Unequal Treatment of Creditors: Paying a Supplier’s Pre-filing Debt in a Proposal Under the Bankruptcy and Insolvency Act

April 15, 2022

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We were approached by a company to assist with its restructuring. Our client’s biggest problem was that its largest unsecured creditor was also its main supplier. Approximately 80% of the client’s business depended on the products supplied by this supplier. This would not be a problem if the client and the supplier had an ongoing agreement to continue to supply, but there was no such agreement. The supplier could cut our client off at any time and had no legal obligation to continue to accept our client’s business.

To be successful after the restructuring, the client needed continued supply from the supplier.

We hoped to negotiate favourable payment terms with the supplier. Instead, the supplier told us that if its pre-filing debt was not paid in full, it would not supply, even on a cash on delivery basis.

Clearly the supplier was a critical supplier in every sense of the word. Without the supplier, there was no business.

If the client could have used the *Companies’ Creditors Arrangement Act*, RSC 1985, c C-36 (“**CCAA**”), section 11.4 would have given the court the power to order the supplier to continue to supply. However, the client did not have claims totaling more than $5 million, so the CCAA did not apply to it.

The client’s only option was to use the proposal provisions in the *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 (“**BIA**”). However, the BIA does not have any provisions like section 11.4 of the CCAA. There was no ability to require the supplier to supply.

We were faced with what seemed like an impossible task – negotiate favourable payment terms with a supplier demanding payment of all its pre-filing debt. And we delivered just that – an agreement with the supplier to provide payment terms together with a proposal, approved by the creditors and the court, which paid all the supplier’s prefiling debt.

But how could the supplier be paid all of its pre-filing debt?

A basic tenet of the BIA and insolvency legislation in general is that all unsecured creditors are supposed to be treated equally. Sections 95 and 96 of the BIA are designed to prevent unequal treatment of creditors and to unwind transactions that offend this principle.

However, two cases – one from the Ontario Court of Appeal and the other from the Supreme Court of British Columbia – which say that treating unsecured creditors equally is the norm, but it is not always necessary or advisable.

In *Contech Enterprises Inc.* (Re), [2015 BCSC 129](), the Court approved a proposal that provided for additional recovery for certain creditors that the debtor considered to be "key suppliers". The product that the key supplier supplied accounted for approximately 25 per cent of the debtor's annual sales. If the key supplier refused to continue to supply products, it was unlikely that the debtor could continue to carry on business. The key suppliers would receive this additional amount if they first agreed to continue to supply product to the debtor on terms acceptable to the debtor.

In *1732427 Ontario Inc. v 1787930 Ontario Inc.*, 2019 ONCA 947, the Ontario Court of Appeal held that a debtor and a creditor could enter into an agreement for the payment of past debts in order to secure future supply. The Court said that denying a debtor this ability would undermine attempts to successfully reorganize as a going concern. Creditors and debtors alike benefit from the debtor's continued operations. The goal of the stay and preference provisions of the BIA is to give the debtor some breathing room to reorganize. Legitimate agreements with key suppliers also form a vital part of that process.

With the legal framework in place, we prepared a proposal which would pay 100% to the supplier and a much smaller dividend to the remaining unsecured creditors. The creditors were placed into two separate classes – the supplier in its own class and the remaining unsecured creditors in their own class. This ensured that the remaining unsecured creditors would not be "swamped" by the much larger supplier and had the opportunity to independently approve the proposal.

The remaining unsecured creditors recognized that while there was a certain unfairness in the proposal, the supplier held all the cards. If the supplier stopped supplying, the distribution to all creditors would be even lower. While agreeing to a 100 per cent payment to the supplier must have been a hard pill to swallow, it was better than the alternative, and they accepted the proposal (which was ultimately approved).

Takeaway

In a proposal under the BIA, a debtor can pay more to one creditor in certain circumstances:

1. That creditor is a major supplier;
2. There are no other realistic options for supply;
3. Without the supply the debtor is unlikely to succeed post proposal; and
4. The supplier agrees to continue to supply to the debtor on terms that are favourable to the debtor.

While in our case the product supplied by the supplier accounted for 80 per cent of the client's business, according to *Contech Enterprises Inc. (Re)*, the amount could be as low as 25 per cent.

Implicit in the agreement to continue to supply is that there is no pre-existing agreement between the supplier and the debtor which obligates the supplies to continue to supply.

In our case the negotiation included granting the supplier security which in turn resulted in more favourable payment terms.

The situations in which one unsecured creditor can be paid more than others are still rare, and rightly so. It's not enough that a creditor wants to be paid (they all do). The situation must be such that paying the one creditor more is the only way to create value for all the other creditors and stakeholders.

The information and comments herein are for the general information of the reader and are not intended as advice or opinion to be relied upon in relation to any particular circumstances. For particular application of the law to specific situations, the reader should seek professional advice.

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