One of the objectives of an efficient insolvency and bankruptcy system is that it discourages both premature liquidation and deferred liquidation.[64] Premature liquidation arises because over-caution by directors and officers leads to filing of bankruptcy prematurely, or creditors move to enforce their claims on all or substantially all of the assets without a prior determination of whether there is going concern value in the enterprise. Deferred liquidation is where directors and officers have not acted in a timely manner to deal with the firm's financial distress, specifically, to file under the *CCAA* or under the proposal or bankruptcy provisions of the *BIA* in a timely manner; hence there has been unnecessary further depletion of assets that would harm creditors' claims. Allowing auditors to act as monitors can arguably assist in reducing both premature and deferred liquidations by encouraging the debtor's directors and officers to file in a timely manner and determine whether there is a viable business plan that may be acceptable to creditors on a going forward basis. In *Hickman Equipment*, the court found that this was a reason for allowing the auditor to act as monitor.[65]

Andrew Kent and Wael Rostom have suggested that the role and functions of a monitor were conceived of as being different from those of a trustee, and that Parliament did not view the roles as a conflict.[66] They suggest that the issue is more one of perception about the appearance of fairness and integrity in the restructuring process rather than an issue of substance.[67] They observe that while the monitor in the Royal Oak and Canada 3000 cases filed material adverse change reports, these reports are extremely rare.[68] Kent and Rostom suggest that increasingly, the monitor is taking on the role of "super-monitor", performing a whole new range of functions, including:

- the monitor frequently advises management on how to adjust to the restructuring process and deal with the various stakeholder groups at the same time that the monitor is monitoring compliance by the debtor with the various restrictions contained in the initial order;

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[64] Sarra, *supra*, note 48 at chapter 2.

[65] *Hickman Equipment*, *supra*, note 46 at paras. 8, 23 and 49.

[66] Andrew Kent and Wael Rostom, "The Auditor as Monitor in CCAA proceedings: What is the Debate?", in *Annual Review of Insolvency Law* (Toronto, Carswell, 2004) at 197-210, citing Canada, Parliament, "Proceedings of the Standing Senate Committee on Banking, Trade and Commerce" Issue No. 17, February 11, 1997.

[67] *Ibid.*

[68] What is not clear is whether they are rare because they are generally not required, or whether the authors identified a problem that needs to be addressed.

- the monitor increasingly acts as the debtor's financial advisor, particularly in respect of small or mid-sized companies in order to realize substantial cost savings;
- the monitor can facilitate constructive negotiations between the debtor and creditors with respect to the terms of the restructuring, particularly where creditors do not have full confidence in existing managers;
- in some cases, the monitor has effectively replaced the board and senior management and has assumed control of the reorganization process, usually as a result of a loss of confidence in management. An example is the *Royal Oak* case.[69]
- In a number of cases, the monitor has either expressly or impliedly been appointed as a receiver to run a sales process for all or for a substantial part of the business or property of the debtor.

Kent and Rostom observe that while the flexibility in the role is a positive development, the traditional view that it is inappropriate for an auditor to act as a receiver is complicated where the monitor is directed to run a disposition process as if the monitor were a receiver.[70] They have proposed a number of possible techniques to rebalance the role of the monitor in the court process.[71] There should be greater clarity about, and disclosure of, the roles actually being performed by the monitor in each particular *CCAA* case. They argue that there may be situations where the court and creditors would expect the monitor not to make recommendations, for example where the monitor has helped the debtor to negotiate a material transaction. They also suggest that in cases where the monitor is more than a watchdog and is acting as a financial advisor to the debtor, the monitor should not be treated as an officer or agent of the court.[72]

David Baird has proposed that the duties of the monitor should be divided up, creating an "administrator" appointed by the debtor and a monitor appointed by the creditors' committee.[73] He suggests that the administrator would be responsible for all the administrative procedures required for processing and implementing a plan of arrangement, similar to a proposal trustee under the *BIA*, including the accuracy of the cash flow statements, receiving proofs of claim and

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[69] *Royal Oak Mines Inc. Re* (1999), 11 C.B.R. (4th) 122. Kent and Rostom observe that industry groups have recommended that the power to appoint a manager be expressly incorporated into the *CCAA*, citing The Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals, *Joint Task Force on Business Insolvency Law Reform: Report*, (March 15, 2002) at 50.

[70] Kent and Rostom, *supra*, note 66.

[71] *Ibid.*

[72] *Ibid.*

[73] David Baird, "Moral Dilemmas Relating to Accepted Insolvency Practices", (2003, CAIRP Educational Forum) at 9.

calling meetings of creditors. Under Baird's proposed model, the administrator would be able to assume the role of financial advisor, strategist and advocate for the company if the debtor corporation wished, and that in such a defined role, the auditor could act as administrator. Baird then argues for a narrower role for the monitor, dealing with matters where independence from the debtor corporation was required, commenting on the reasonableness of the cash flow statements, acting as whistle blower if there is a material change of circumstances and commenting on the merits and fairness of the plan.[74]

If the harm to be prevented is conflict of interest or perceived conflict of interest, then the statutory language needs to address more fulsomely the role of auditor and of monitor. The auditor as financial advisor of the debtor should be prohibited from being monitor, yet an auditor that has acted as outside, independent auditor in a disinterested manner could perform the role, if the role is to monitor only, as narrowly defined. Similarly, the auditor that has become too closely involved in the debtor management's decision making should be precluded from being monitor, as that involvement may impair its ability to provide an impartial opinion on the financial statements. The statutory definition of the monitor also requires some clarification. The monitoring, reporting and mediating functions of the monitor should be distinguished from the advocacy and financial or business advice functions. Where the monitor is performing the latter, it is not really acting as a monitor, and hence should perhaps be called something different to reflect that it is not an officer of the court rendering an impartial opinion on aspects of the proceeding. It is not the title of auditor or monitor that is problematic, but rather the scope of duties and conflicts that must be more properly identified and, where necessary, separated. This needs statutory codification. In the interim, the courts should be careful to discern the role of the monitor and the amount of deference that should be accorded its opinion. There should be a means for creditors to express their opinions as to the propriety of the monitor's role in advance of the court's appointment or very shortly afterward, with meaningful scrutiny by the court of any concern about impartiality or any conflict.

E. Multiple Roles of Trustees and Receivers under the *BIA*

In Canada, it is common that insolvency professionals act in more than one capacity. The court has held that the court-appointed receiver is neither an agent of the security holders nor of the debtor, rather, it acts on its own behalf, its duties are set out by the appointing order and it reports

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[74] *Ibid.* at 10.

to the court as a means of being accountable to the court and to all interested parties.[75] Yet acting in more that one capacity can raise issues of potential conflicts of interest. For example, in *Commonwealth Investors Syndicate Ltd.*, the court revoked the appointment of a trustee who was also acting as co-liquidator of the subsidiaries of the bankrupt debtor.[76] The court found that in the circumstances, the trustee was not acting independently and appeared to side with the group of companies in which the trustee acted as co-liquidator, contrary to its fiduciary obligation. In *Illidge (Trustee of) v. St. James Securities Inc.*, the Ontario Court of Appeal set aside the appointment of an insolvency practitioner as receiver where it had acted as trustee of two bankrupt companies and an individual bankrupt and was subsequently appointed as receiver of two other companies.[77] The Court found a conflict of interest existed between the parties under the control of the insolvency practitioner and set aside the receivership appointment.

The courts have held that the trustee is to act impartially and conduct itself in such a manner as to avoid conflict, real or perceived between the trustee's interest and duty.[78] The courts have also held that where a private receiver is also acting as a trustee in bankruptcy, the trustee as an officer of the court must represent all creditors and ensure that conflicting interests are resolved equitably.[79] Thus the privately appointed receiver acquires a broader obligation than only to the creditor that appointed it, once it takes on the role of trustee. Where the receiver is court-appointed, it already has a duty to the court and to all creditors that continues in its capacity as trustee. The trustee must not only act without interest or bias, but must be perceived to be acting without bias.[80]

An insolvency professional may be a trustee and a receiver in the same engagement, appointed as trustee by creditors, the Superintendent of Bankruptcy or the court,[81] and privately appointed as receiver by the creditor or appointed by court order on a creditor's request. The privately appointed receiver becoming trustee occurs because the secured creditor may be able to benefit from having its receiver act as trustee, including the full range of investigation and realization powers under the *BIA*, the ability to pursue reviewable transactions, the trustee's ability to

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[75] *Re Bakemates International*, *supra*, note 55 at para. 34.

[76] *Commonwealth Investors Syndicate Ltd.* [1986] 61 C.B.R (N.S.) 147 (B.C.S.C.).

[77] *Illidge (Trustee of)* v. *St. James Securities Inc.* (2002), 34 C.B.R. (4th) 227 (Ont. C.A.).

[78] The test is an objective one, see *Tannis Trading Inc.* v. *Cam Food Services Ltd. (Trustee of)* [1988] 67 C.B. 1 (Ont. S.C.); *Piscines et Patios G.H.O. Inc.* (1991) J.E. 88-926 (C.s. Qué.).

[79] *Prince Edward Island* v. *Bank of Nova Scotia* (1988), 70 C.B.R. (N.S.) 209, 72 Nfld. & P.E.I.R. 119, (P.E.I.T.D.), reversed on other grounds, (1989), 81 Nfld. & P.E.I.R. 295 (P.E.I.C.A.).

[80] *Ibid.*

[81] Sections 14, 14.03, 14.04, *BIA*.

disclaim leases, and the economies that are generated by having the receiver who is already familiar with the debtor's business affairs act as trustee. In such cases, the trustee is an officer of the court, but may have obligations to the secured creditor in its receivership role. The duty under both roles is to act honestly and in good faith and to deal with the property of the bankrupt in a commercially reasonable manner.[82] A trustee under the *BIA* generally acts subject to the rights of secured creditors, and its powers of inspection, valuation and realization are highly codified in the *BIA*.[83] The trustee's primary obligation is to the court and to unsecured creditors, and its actions are subject to approval by unsecured creditors either through creditor votes or the decision making of inspectors appointed to represent unsecured creditors.[84] The receiver's obligation is to the secured creditor that appointed it, and more generally to other creditors and the debtor in terms of its conduct both in disclosing and in realising on assets and distributing the proceeds.[85]

Hence, where there is appointment as both trustee and receiver, the insolvency professional has reporting responsibilities and duties that may conflict. For example, the inspectors may challenge the approach taken by the receiver in disposing of secured assets in terms of the value realized or the adequacy of the sale process. There is also a potential conflict of interest where the trustee is asked by unsecured creditors to challenge the security because of improper registration or perfection. The potential for conflict also arises where the trustee has an expectation of future business with the secured creditor, creating some pressure to act in its interest to the exclusion of other creditors and the debtor. While there should not be confidentiality where the trustee has multiple obligations, there may be normative pressure by the secured creditor that has retained the trustee to not disclose information to which it has been made privy.

The *BIA* allows trustees to act on behalf of a secured creditor, although it specifies that a trustee shall not take on this engagement unless the trustee has an opinion from counsel independent of the secured party that the security is valid and enforceable against the bankruptcy estate.[86] Bankruptcy Directive 15R specifies that where a trustee realises on a secured creditor's assets, the trustee must maintain a written record of the capacity and terms under which the trustee

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[82] Section 247, *BIA*.

[83] Sections 69-69.4, 70, 79, 81, 127-135, *BIA*.

[84] Sections 30, 31, *BIA*.

[85] Sections 245, 246, *BIA*.

[86] Section 13.4, *BIA*.

operates on behalf of the secured creditor; and must also maintain sufficient accounting records to segregate the costs and activities undertaken for the benefit of the secured creditor.[87]

Daniel Dowdall has observed that trustees are frequently uncritical in examining the opinion that the security is valid and enforceable.[88] He suggests that this is particularly problematic where security is taken between related parties and there are problems with adequate corporate authorization and defects in execution. Yet trustees may decide that an examination of the minute books or other investigation is not worth the costs for the potential identification of deficiencies.[89] Dowdall cites a series of other conflicts issues in these circumstances; specifically, problems where there is a dispute regarding the amount owed to the secured creditors; issues regarding who gets the benefit of successful reversal of a fraudulent conveyance transaction; secured creditor refusal to let surplus proceeds be paid out because of concern about potential environmental claims or warranty claims; or where the inspectors arrive at a different conclusion about the "best course of action" that the trustee pursued on instruction of its secured creditor client.[90]

Other possible conflicting roles include acting as a trustee in bankruptcy for a series of affiliated companies that may have intra-corporate transfers of assets or debts; acting as trustee when the trustee's accounting firm is a major creditor of the bankrupt or acts for a major creditor of the bankrupt. The Ontario Court of Appeal has held that a trustee in bankruptcy will not be removed on the grounds of conflict of interest where the trustee is also a privately appointed receiver if the trustee has made full disclosure of the possible conflict, the complaining party delays in objecting and there is no evidence of real prejudice.[91] Section 13.3(2) of the *BIA* requires that the trustee disclose whether it is the trustee or receiver of a related entity. Yet disclosure does not address the potential conflicts issues, particularly where there may be reviewable intra-corporate transfers of assets.

When acting under proposal provisions of the *BIA*, the trustee has a duty of care to the creditors. As a court-appointed officer, the proposal trustee reports to creditors on the merits of any

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[87] Bankruptcy Directive No. 15R. "Costs and Disclosures Associated with the Realization by the Trustee of Secured Creditors' Assets". See also Bankruptcy Directive 10 "Redemption of Security and Section 147 Levy of the BIA", which provides for an accounting and segregation of costs where the trustee sells both encumbered and unencumbered assets in the same transaction.

[88] Daniel Dowdall, "Ethical and Conflict Issues for Insolvency Practitioners", Superintendent of Bankruptcy Tutorial, at 10 (on file with author).

[89] *Ibid.* at 11.

[90] *Ibid.* at 12.

[91] *R. J. Nicol Construction Ltd.* v. *Nicol* (1995), 30 C.B.R. (3d) 90 at 93 (Ont. C.A.).

proposal and must ensure sufficient disclosure of the finances of the debtor so that creditors are able to make an informed decision as to whether to vote in favour of the proposal. The trustee named in a notice of intention to file a proposal is required to file a report on the business and affairs of the debtor where there is any material adverse change in the projected cash flow or financial circumstances or on any application for an extension of the stay period, commenting on the prospects for devising a viable proposal.[92] Bankruptcy directives emphasize that the credibility of the bankruptcy and insolvency system depends on the trustee's objectivity in the process and on full and fair disclosure of relevant information.[93] Yet the proposal trustee is also to advise the debtor on how to craft a proposal that is most likely to give a chance to rehabilitate the debtor and to secure the requisite creditor support in the proposal process. At the same time, the trustee is required to report on the reasonableness of the debtor's statement of projected cash flow.[94] While there are potential conflicts here, it also seems evident that the trustee's role is to engage in a balancing, having regard to the interests of all stakeholders. This may not be sufficiently codified in the statute.

There are several principles and best practices that aimed at avoiding these conflicts:

- Disclosure at the outset of any insolvency or bankruptcy process of whose interests the trustee is acting on behalf of, including written explanation of any potential conflicts of interest that are likely to arise;
- obtain some assurance of informed consent, either through parties seeking independent legal advice or having the stakeholders sign an acknowledgement as to the nature of the relationship;
- meet statutory requirements for notice to creditors and inspectors of a dual appointment, the basis of remuneration and notice of the legal opinion as to the validity and enforceability of the security under which the receiver is acting;[95]
- scrutinise the "valid and enforceable" opinion, in the interests of all stakeholders;
- have clear policies regarding the communication of confidential information and clear processes for disclosing this policy to creditors, inspectors and other stakeholders in the insolvency or bankruptcy process, including how the scope of disclosure may shift if the role of the professional shifts from receiver to trustee or other role (statutory guidance in this would be helpful);

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[92] Section 50.4(7), *BIA*.

[93] Bankruptcy Directive No. 20, "Information to be Provided to Creditors in Commercial Proposals".

[94] Section 50.1, *BIA*.

[95] Section 13.4, *BIA*.

- enforce a standard of good faith dealings and impartiality in dealing with all stakeholders;
- develop ongoing processes for monitoring conflicts of interest;
- develop a mechanism whereby the trustee or other insolvency professional can resign from the engagement or shed the conflicted activity to an insolvency professional who will act in the best interests of the creditors; and
- provide ongoing training of insolvency professionals on the nature and scope of potential conflicts and the need for ethical standards that eliminate the conflicts.

III. Personal Insolvency and Bankruptcy and the Role of Professionals

In Canada there were 84,251 consumer insolvencies in 2003, up from 10,000 bankruptcies annually 25 years ago.[96] Since the introduction of consumer proposals in 1992 as an alternative for debtors to work out their affairs and avoid bankruptcy, the number of consumer proposals has grown to 15,400 annually.[97] While the *BIA* refers to "consumer" bankruptcy and proposals, practitioners and those in the reform process have recommended changing this to "personal", to better reflect the realities of individual financial distress. Both terms are used in this paper.

The number of trustees involved in personal bankruptcy files has also grown considerably. While precise figures are not available, the OSB reports that of 900 licensed trustees working in 250 firms or sole practice, there are approximately 170 firms/individuals that file at least 100 personal insolvency and bankruptcy files each year.[98] This means that roughly 500 trustees are engaged in personal insolvency. The language of the statute is that the Official Receiver selects the bankruptcy trustee with regard to the wishes of the most interested creditors,[99] yet in practice, the debtor selects the trustee. The trustee performs a number of functions, including ascertaining from the debtor the reasons for the financial distress, explaining the options available to the debtor, collecting and realizing on the assets for the benefit of creditors, and reporting to the OSB. The trustee is paid on a priority basis out of the assets of the estate.[100] As discussed above in respect of commercial bankruptcies, the trustee has an obligation to creditors. Best

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[96] OSB, *Annual Statistical Report, 2003*, *supra*, note 25 at Table 4. See also Personal Insolvency Task Force, *Final Report*, (Ottawa, Industry Canada, 2002) ("PITF Report") at 6; OSB, *Bankruptcy Statistics for Calendar Year 2001*, Tables 2 and 4B, http://strategis.ic.gc.ca/epic/internet/inbsf-osb.nsf/vwGeneratedInterE/h_br01011e.html

[97] OSB, *ibid.*

[98] OSB, on file with author.

[99] Section 49(4), *BIA*.

[100] See the discussion below on trustee fees.

practice suggests that the trustee should explain its obligations at the outset, be satisfied that the debtor understands the nature of the trustee's obligations, and have the debtor sign acknowledgement of the relationship.

The issue of confidentiality is one issue where potential conflicts and ethical issues arise. The trustee, in first interviewing the debtor to ascertain the reasons for the financial distress and to canvass the options available, may hear information regarding transactions that are reviewable or particular preferences or settlements made by the debtor in the period leading up to filing for bankruptcy or filing a notice of intention to make a proposal. If the trustee has not been absolutely candid at the outset of the meeting that the trustee is there to represent the creditors, the trustee may face a serious conflict in terms of the ethics of either taking on the engagement or of reporting the conversation to the trustee that ultimately does take on the assignment. Best practice suggests that the trustee be clear about the professional obligations at the outset, that the trustee advise the debtor to disclose the transactions and that the trustee pursue investigation of the impugned transaction. Yet there may be pressure to ignore these ethical practices in order to secure the file.

As with commercial insolvency practitioners, there has been a paucity of writing on the role of the personal insolvency professional in Canada, particularly in respect of ethical issues, although this discussion is now starting to occur.[101] The Personal Insolvency Task Force Report, commissioned by the federal government to study and make recommendations on reform of the *BIA*, commented on the vital role of trustees in the process. However, two of the three academics on the PITF dissented in the final report, primarily on the issue of the role of trustees, potential conflicts of interest in the process, the failure to undertake empirical research during the reform process and the failure to consider more fundamental, public alternatives to the current private/public system of bankruptcy.[102] Subsequent commentary by the two dissenting scholars has included a more direct critique of trustees. It is worth examining some of the issues raised in an effort to think about the future direction of the practice and questions of conflicts of interest and professional ethics.

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[101] David Wood and Guylaine Houle have both recently written on this subject, providing a helpful starting point for thinking about the role of the professional in personal insolvency and bankruptcy cases. David S. Wood, "The Role of the Trustee in Personal Insolvency Matters", *Annual Review of Insolvency Law, 2003*, (Toronto, Carswell, 2004); Guylaine Houle, "Ethics in the Practice of Personal Insolvency Law", paper presented to the first Annual Conference on Review of Insolvency Law, UBC Faculty of Law, Vancouver, (6 February 2004), on file with author.

[102] Ramsay, *Reservations and Dissent, Personal Insolvency Task Force Final Report, supra*, note 96 at 93; Jacob S. Ziegel, *Reservations and Dissenting Views on the Task Force Report, ibid.* at 97.

Professor Iain Ramsay has been the most vocal in his critique of the profession and reform efforts. He uses public choice theory, a method of analysis by several bankruptcy scholars in the United States, to analyse the development of Canadian bankruptcy law.[103] Essentially, public choice theory suggests that rational self-interested actors maximize their utility (benefits to self) and engage in rent seeking (which means that it is not economically justifiable that these actors get the benefits they are seeking, i.e. a monopoly on benefits) in the political reform process. Ramsay observes that consumer debtors as a diffuse group are likely to be less effective in successfully lobbying for political change than well-organized groups such as trustees.[104] He has suggested that although licensed by the Office of the Superintendent of Bankruptcy, trustees have a monopoly in Canada on bankruptcy processing. He observes that while most trustees are accountants, trustees are not a self-governing profession like lawyers and accountants, although they aspire to this status.[105] Professor Ramsay suggests that the aim of trustees is to maximize income and prestige and hence they have a strong opposition to any substitute of public for private processing of bankruptcy as it would reduce the market for their services.[106]

There is a valid critique that consumers of bankruptcy legislation were not adequately represented in the PITF process and are too diffuse a group to have their views influence the legislative reform process. Yet the critique may underplay the challenge of truly having those voices heard in the political process. Those that are bankrupt do not have the energy, information or resources to lobby politically. Other debtors do not believe that they will ever be bankrupt and hence are unlikely to be interested or engaged in the process. Those that have survived bankruptcy frequently wish to leave the stigma of bankruptcy that still exists behind. There are also a myriad of reasons why consumer bankruptcy groups have not developed in Canada, an issue largely ignored in the legislative reform debate. It ignores that there are profound power imbalances such that even if consumers had been represented on the PITF, it is unlikely that their voices would have prevailed.

While public choice theory explains some aspects of political processes, it has considerable limits as an analytical tool. It masks the normative approaches by parties in their lobbying efforts, reducing their positions to positioning for purely economic self-interest. It is bankruptcy's law and

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[103] Ramsay, *supra*, note 7 at 382-384.

[104] David Skeel Jr., *Debt's Dominion, A History of Bankruptcy Law in America* (Princeton: Princeton University Press, 2001); A. I. Ogus, *Regulations Legal Form and Economic Theory* (Oxford: Clarendon Press, 1994); I. McLeod, *Public Choice: An Introduction* 2d ed., (Oxford, Blackwell, 1996).

[105] Ramsay, *supra*, note 7 at 388.

[106] *Ibid.* at 388 citing the example of trustees lobbying to eliminate the publicly administered program in the 1970's.

economics version of the rational actor theory, a theory that ignores bankruptcy professionals, debtors and others as socially situated. Public choice theory, in reducing all groups to a single self-interest ignores the diversity of professionals working in personal bankruptcy law and their multiple objectives for working in the field. Just as lawyers, academics and others cannot be lumped into one group with single income maximizing self-interest driving all views, public choice theory tends to reduce political and policy decisions to a one dimensional view of trustees. Hence, the analysis put forward by scholars such as David Skeel in his book on the history of U.S. bankruptcy law and public choice theory is interesting, but very thin on an overall normative framework for thinking about bankruptcy law.

The two dissenting scholars in the PITF process have, however, raised some relevant points that the profession should address, preferably prior to the next stage of the legislative reform process. These include the failure to undertake empirical study; the inherent conflict of interests of trustees; payment of trustees; and the issue of "trustee shopping". These are addressed in turn below.

A. Lack of Empirical Research on Personal Insolvency and Bankruptcy

First, is the critique that there is a lack of empirical data on which to base bankruptcy reform recommendations. This is a valid critique. To date, there have been very few studies on Canadian consumer bankruptcies, the incentive effects of particular policy choices, the economic and social barriers that contribute to bankruptcy and comparative analysis with other systems internationally. There have been some qualitative studies that have been hotly critiqued by the profession. Yet in the absence of alternative and better data, it is difficult for the casual observer to assess both the studies and their critiques in terms of what they tell us about the bankruptcy system. The PITF was given neither the time nor resources to undertake comprehensive research studies. Similarly, while Industry Canada policy analysts have made considerable efforts to broadly consult with stakeholders in the reform process, it is less than clear whether they were given sufficient resources on the personal insolvency side to undertake empirical research into both the Canadian system and comparative systems internationally. While this was clearly a government decision, it may be that the profession has a role in either funding better empirical research on an arm's length basis, or in pressing the government to undertake this.

One example is the debate regarding whether or not there should be a publicly funded process for judgment-proof debtors, those that have assets and income that are exempt from seizure by creditors. The debate during the PITF process was whether to create a separate regime that provides an alternative to those debtors that have no assets that would be available to satisfy creditors' claims but who require relief from aggressive debt collection efforts. The PITF considered a system in which debtors would be given relief from debt collection efforts and then monitored for an extended period to ensure that they remained without non-exempt assets or surplus income; however, it rejected the alternative as unmanageable given the mobility of the population and barriers to effective monitoring.[107] The points raised by the PITF were valid, yet the dissenting reports of the PITF criticized the lack of consideration of other alternatives to address this problem.[108] In part, this critique was aimed at a failed opportunity to more fulsomely consider the objectives of the personal bankruptcy system as a form of consumer protection, a social welfare mechanism or a creditor's remedy, and the failure to undertake the research to inform this discussion.[109] Professor Ramsay has suggested that research in the reform process should have included research exploring some of the central concepts of personal insolvency law; economic analyses of different models of bankruptcy law and service delivery; and data collection on both public perception and the direct experience of those involved in the system, including an assessment of the success or failure of the proposal process since it has been enacted.[110] This is a critique of the legislators more than the PITF, in the sense of resources directed at the process. It is notable that other public policy initiatives have had considerably more resources directed at study before the policies are implemented. Hence personal bankruptcy is the poor cousin of other public policy areas in terms of research dollars allocated in public policy decisions, just as welfare has historically been at the provincial government level.

Historically, there was a publicly funded trustee agency in Canada called the Federal Insolvency Trustee Agency (FITA), which operated from the early 1970's until approximately 1980. Why it was dismantled is somewhat contested and there are diverse recollections, including: that there was concern that legally the FITA was not properly constituted, given the statutory language; that trustees lobbied the federal government to end FITA and move the cases to the private sector because of a belief that there was a profit to be made from administering these files; or that the federal government, as part of its overall shift to privatization, was eager to get out of FITA and have the private sector take over. FITA was replaced by variations of what was known as the "referral program". Initially, under this program, debtors would submit applications to the OSB. An OSB officer would perform a screening interview with the debtor and then refer the debtor on a rotational basis to the next trustee on the "referral list" of trustees that had agreed to handle these files for little or no up-front fee. Eventually, the screening interview was dropped

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107 PITF Report, *supra*, note 96 at 70-71.

108 Iain Ramsay, *Reservations and Dissent, PITF Report*, *supra*, note 102 at 93.

109 *Ibid.* at 94.

110 *Ibid.*

and the practice in most of Canada by 1982 was that applications from debtors were simply turned over to the next trustee on the "referral list". A major problem was that there were restrictions on the numbers of trustees allowed on the "referral lists" in some regions, which prompted the excluded trustees to claim that it was unfair to only allow some trustees on the lists. Another criticism was that the OSB offices were spending an inordinate amount of time simply receiving applications and then forwarding them on to trustees. As a consequence, in 1985 or 1986, the Bankruptcy Assistance Program came into effect following lengthy discussions with the trustee association and a joint committee made up of OSB representatives and trustees. At the time, it was believed that the program would only be used by a very small number of debtors and that trustees would generally be able to handle the vast majority of files in the first instance, a belief that has proven to be the case.[111]

Hence, one is left with some uncertainty as to whether or not there is a problem of access to the bankruptcy system for the least well-off debtors. Intuitively, given that 80-85% of all bankrupts have no surplus income, it seems that there must be. Yet the OSB reports that it receives less than 500 cases under its Bankruptcy Assistance Program each year and is able to find trustees to perform bankruptcy services at less, little or no cost where necessary. It does not receive complaints that this program has not assisted. Given no apparent problems at the door of the oversight agency, it is not surprising that more interest in this was not generated in the process. The difficulty is that a lack of a public voice about these issues does not mean that there is not an access problem, and absent empirical research one will not know. As a consequence, the debate takes place on the basis of different normative views about access in Canada, as opposed to a deeper understanding of the problems that may exist. No doubt, there would be problems in collecting the data, but they are not insurmountable. Debtors that reach the low point in the social safety net end up in the welfare system and this highly codified regime would provide one source of gathering information about debtors who have not accessed the bankruptcy system. This would not generate data regarding those who have fallen one step further through the last social safety net, but it would be a start.

What is the responsibility of the profession in pushing for study of these issues? From an "other-interested" perspective, it would support ensuring the best reform process possible and assist in giving voice to a range of constituents whose first-hand views are not currently in the public domain. Self-interestedly, support for research may substantiate trustees' own professional experience with debtors in terms of whether or not there are barriers to the system. Either way, it would allow for more informed decision making about the appropriate role and limitations of

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111 My thanks to the OSB for providing this history of the program.

trustees as insolvency professionals and lend more credibility to the perception of trustees as professionals that balance diverse interests in the bankruptcy and insolvency system.

B. The Inherent Conflict of Interest of Trustees in the Legislative Reform Process

This is a touchy subject for insolvency professionals, because, as noted above, trustees have given countless volunteer hours on the PITF, in working groups in their professional organization the Canadian Association of Insolvency and Restructuring Professionals (CAIRP), and in their direct service efforts to consumer debtors. These efforts are aimed at debating and arriving at as broad a consensus as possible about reforms that would enhance the transparency, accessibility and efficiency of the insolvency and bankruptcy system.

There is a great difference between conflicts of interest inherent in the political reform process and the notion of conflict of interest in the practice of personal insolvency law. As academics, we experience conflicts of interest daily, in promoting our particular normative conception of insolvency law, in advocating that more research dollars be directed towards studying the system, and in suggesting areas of attention that resources and public policy debate should direct towards regulatory reform regarding corporate activity. Trustees and other professionals similarly face inherent conflicts of interest in that they have an economic stake in the current system, although that stake differs considerably among the trustees, just as it does among academics. This inherent conflict of interest and diversity of views is key to the democratic process. Policy reform occurs when advocates in the system acknowledge their history and biases and then work through the issues with other stakeholders to seek the appropriate balance in the bankruptcy and insolvency system. The challenge is how to broaden the current representation at the table, while recognizing both the valuable contribution and the potential conflicts that the profession brings to the table.

Both dissenting reports of the PITF Report criticized the failure of the PITF to more fundamentally consider the role of the trustee in the personal bankruptcy process.[112] In particular, whether the current role of simultaneously advising and counselling the debtor and acting as representative of the creditors is the best means of providing service to a particularly vulnerable population.[113] As Professor Ramsay noted in his dissent, whether the potential dangers of such a conflict of interest are outweighed by the reduction in transaction costs in the processing of bankruptcies is an

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[112] Ramsay, *supra*, note 102 at 95; Ziegel, *supra*, note 102 at 99.

[113] *Ramsay, ibid.*

undetermined question.[114] Professor Ziegel observed that many trustees advertise their services in a manner that leads debtors to believe the trustee is protecting their best interests when, in his view, the law is clear that the trustee's primary obligation is to the creditors and the bankruptcy court.[115] The conflict of interest issues are complex. Rather than shirk from a full debate on these controversial questions, the profession ought to fully engage in the debate with its principal critics, as a means of both increasing public information on the role of trustees as a multifaceted officer in the process and as a means of closing gaps in the data that could aid the reform process.

What is not recognized in this critique on the role of trustees in the reform process to date is the countless hours that trustees spent in working groups of trustees across the country, analysing not only the draft PITF report, but in generating numerous ideas about where reform is needed.[116] Represented by region, gender, size of practice, years of practice and cultural differences, the debates in these working groups were vigorous and extended. They also involved months of discussion to arrive at a consensus about what reforms might be necessary. While the debates were among trustees alone, they speak to the profound diversity of experience across Canada with consumer bankruptcies and a range of concerns about vulnerable participants in the system. The more than 100 trustees involved in this volunteer effort, roughly 1/5 of all consumer trustees in Canada, sheds considerable insight on problems encountered on the ground by trustees and the debtors that engage their services. This process illustrates that the interests of trustees are considerably more layered and nuanced than a depiction of trustees as monolithic self-interested wealth maximizing actors. Is this a communication problem in terms of the public's perception? Perhaps in part, but it goes to the broader question of how trustees are portrayed in the media, in the academic literature and self-portrayed by a small segment of the trustee population. This does not address the problem of lack of a direct consumer voice in the reform process, but it does indicate a broader and more diverse set of voices than indicated in the literature.

In any political reform process, all the actors are driven in part by their biases and their conflicts of interest in advancing their particular position. Rather than ignore this, it is important to analyse how the conflicts of interest of all participants can be tempered to realize the best reforms possible. It would likely not have been sufficient to have consumers represented in the process, because the relative imbalance in power between consumers, creditors, trustees and government officials is such that it would have been difficult to overcome. Thus there should be consideration of how to represent these voices in the process going forward, either through appointment of

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[114] *Ramsay, ibid.*

[115] Ziegel, *supra*, note 102 at 100.

[116] CAIRP and IIC Submission to the Senate Committee on Banking, Trade and Commerce, February 2003.

representative counsel or some empirical surveying. Criticism should be viewed as a positive aspect of the debate, not because academics any better represent the views of consumer debtors than trustees, but because as a society, it helps provide us with a sober second check on the scope of our views that are "other-interested" and those that protect self-interest.

C. Conflicts of Interest in Practice

The discussion about the legislative reform process, where conflicts of interest are inherent for all participants in the process, is very different than the issue of conflicts of interest in the practice of personal insolvency and bankruptcy. This is an incredibly important distinction and one that is underplayed in the current reform debate. Whatever one's normative views are about the growth of personal bankruptcy as a public process performed by private professionals, this was a choice made in earlier reform processes in Canada. While there is legitimacy to the debate about whether there needs to be a more fundamental rethinking of the system, there is a separate set of questions about whether, in the current system, trustees act ethically and largely without conflicts of interest. Here there is some empirical data. While the trustees engaged in fraudulent activity have attracted media headlines, only a tiny fraction of trustees have been found to have engaged in non-professional practice. The Superintendent of Bankruptcy reports that in the past decade there have only been 30-40 cases of misconduct by trustees in total, roughly 0.4% of all trustees.[117] This misconduct has ranged from inadequate record keeping to more serious breach of trust obligations.

Prior to 1992, only the Minister could take away a trustee's license under the *BIA*. Given the political nature of the role, the Minister usually refused to act on recommendations of the Superintendent of Bankruptcy to remove licenses because of risk of public perception that the Minister was making trustees lose their livelihood. In 1992, that power was vested with the Superintendent. Mechanisms were put in place to investigate and where appropriate, rescind the trustee's licence. The Superintendent conducts a form of dispute resolution in the triage of complaints about trustee conduct. On receiving a complaint, it works with the complainant to determine the validity of the complaint, or whether it is an aspect of the *BIA* not understood by the debtor or creditor that is complaining. It then conducts a dispute resolution process with the trustee and the complainant, trying to resolve the complaint. In most cases, the matter is resolved at that point. Where the Superintendent determines that there is an issue of professional conduct, it conducts a complete audit of the trustee's practice, and takes

[117] Office of Superintendent of Bankruptcy Statistics, on file with author.

conservatory measures where appropriate. In cases of fraud or other serious misconduct, it prosecutes the trustee and undertakes professional disciplinary action, all with due process protections in place.

One of the Superintendent's enforcement strategies in the past year was to identify all those trustees with greater than 15% of estates outstanding for more than three years, and requiring them to provide independent bank verification of money held in trust. It found 99 such cases. While there was considerable complaint by the trustee community about the priorities of the Superintendent in pursuing these trustees, the rationale was one of "triage" type identification of problems. The Superintendent's Office had found that in all the fraud cases to date, a common theme was the failure to close estates in a timely manner. In some cases, there had also been illegal tampering with bank records. Using the fact of the 15% of outstanding estates as an investigative tool for fraud in the system, the Superintendent was able to verify that none of the 99 trustees involved had engaged in fraudulent activity. Hence, it viewed this initiative as focusing on higher risk situations as a preventive or early detection measure.

As noted in Part I, the Senate Committee has recommended increased codification of professional ethics in the *BIA*. In addition to the ethics code currently enshrined in bankruptcy regulations, insolvency professionals that are CAIRP members are subject to rules of professional conduct and standards of professional practice that are increasingly monitored. CAIRP has developed a system of complaints processing and sanction for members that do not conform to its practice standards. As a profession, it publicly reports on the disposition of hearings relating to alleged misconduct and the outcomes. The difficulty is that CAIRP's only available sanction for misconduct is to take away membership; and the impugned trustee frequently quits the Association before misconduct is fully investigated or adjudicated.

D. The Issue of Fees

Another critique of dissenting members of the PITF was the amount of private fees charged by trustees to administer a bankruptcy or proposal. The issue of trustee fees presents a thorny discussion point. Not because it is not important, but because there is a lack of good data on precisely the issues and challenges in respect of the fees issue. There are historical reasons why the administration of the bankruptcy system is undertaken by private professionals, reasons that are beyond the scope of this paper, but which reflect a move by federal legislators to privatize aspects of the public service delivery system. Having made that choice, it does seem counter-intuitive that fees should be an issue, given that the whole question of private delivery of the service has come under little scrutiny in recent years. Leaving that issue aside, there are two issues regarding fees.

First, it is important that trustees be paid fair compensation for their work. The trustee has a first claim for payment of its fees and costs of administration of the estate. While estimates vary, the average consumer bankruptcy charge is about $1,500. In most cases, this fee is not paid at the front end of the process. Rather, where the debtor is employed, it is frequently made in contributions from wages during the nine month period as an undischarged bankrupt. It may also be paid as a percentage of proceeds realized on assets from that portion of the assets than are non-exempt, proceeds that were part of creditors' claims on the estate. Payment also comes from pre- and post-filing income tax returns or GST rebates (to a maximum). This is value that would accrue to the creditors if they were to fully realize on their claims, not to the debtor, an observation seldom made.

The greater challenge is those who are unemployed or on welfare or other social assistance, where there is neither surplus income nor assets. While many have concluded that these individuals are judgment proof and hence do not need to go bankrupt, it is not clear that there is adequate consumer information or assistance in how to get relief from aggressive debt collection agencies. There is a further issue where debtors have to borrow from family or friends in order to pay for the bankruptcy process, a practice that has distributive consequences for persons that are not insolvent, due to the unavailability of a publicly delivered service for the financially distressed family member. It raises the question of whether trustees should encourage this type of payment as ethical practice.

There had been a practice whereby debtors signed agreements that payments for the costs of trustee fees and administration would continue to be made post-discharge where there were not sufficient assets to cover the costs. However, the court in *Berthelette* held that such agreements were not enforceable.[118] The PITF concluded that this ruling limited the flexibility of payment arrangements between trustees and bankrupts and thus reduced the certainty that trustees would receive fair and adequate compensation for the services they provide.[119] It recommended amending the *BIA* to allow trustees to enter into voluntary payment agreements with bankrupts who do not have surplus income, with a ceiling on the sum of trustee fees and other administrative costs of bankruptcy, which would allow the bankrupt to still have an automatic discharge in a timely fashion, but allow trustees to receive their fees and costs.[120] It further

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[118] *Re Berthelette* (1999), 11 C.B.R. (4th), 174 D.L.R. (4th) 577 (Man. C.A.).

[119] PITF Report, *supra*, note 96 at 43.

[120] *Ibid.*

recommended that such agreements would not be permitted in hardship cases. The recommendation has been criticized as contrary to the fresh start principle because bankrupts emerge from bankruptcy with post-discharge payment obligations. This is in contrast to the view that several hundred dollars of post-discharge payment obligations to trustees is a small price for the ability of the debtor to shed onerous debt obligations and emerge from bankruptcy with a fresh start. Both sides of this debate have not yet been adequately addressed by legislative policy makers. On the one hand, delaying discharge dates in order to secure payment disadvantages consumer bankrupts in their credit ratings for a longer period of time. This is a serious prejudice to timely access to bankruptcy discharge. On the other hand, post-discharge payment obligations to trustees could also impede the fresh start principle, although this depends on the nature of the payments and the financial and other circumstances of the bankrupt. Moreover, safeguards for hardship cases in post-discharge payments need to be chrystallized, including a process for dealing with claims of hardship. There is also the question of the distributive consequence of asking trustees to forgo payments for services rendered absent a solution to the problem of compensation. No other profession would be asked to eliminate or reduce fees for services performed, including those dealing with vulnerable populations such as in family law, poverty law and disability law (unless the lawyer has voluntarily agreed to perform *pro bono* work or agreed to work under a legal aid fee structure). Trustees should be paid reasonable fees for the work they perform.

The issue is more complex than simply the ethics of post-discharge payments and the fresh start principle. If the policy objective is access to bankruptcy services, timely and accessible discharge and fair compensation to trustees for providing a public service, should the government step up to the plate and pay trustees for any short-fall in fees due to the debtor's lack of surplus income, thus using the tax base to redistribute wealth by giving bankrupts access to earlier discharge and fresh start? Should there be a public service offered in such cases, i.e. a public trustee available to process bankruptcy where there is no surplus income or assets? Calls to adopt a no-fee or low-fee public system are unclear as to their possible efficacy, absent empirical study of whether or not such systems truly create greater access to rehabilitation in other jurisdictions than the current Canadian system. Moreover, it is unclear that there would be any political will to change the current system, when the surveys that have been undertaken indicate a considerable level of satisfaction with trustees' services. What is the bankrupt's experience in the fees process? Should the credit industry be charged an experience-rated tariff that would fill this compensation gap, much as private industry does for the workers' compensation system? Having made the choice to deliver a valuable public service (bankruptcy and proposal processes) privately, how is the system going to design the appropriate incentives and payment choices to reflect its goals of accessibility, fairness and efficient administration of consumer bankruptcies and proposals? It appears that the current reform debate, on all sides, may have been cast too narrowly, leaving trustees as the "bad guys" in their efforts to ensure they are paid fairly for their labour.

E. Trustee Shopping

Closely related to the fee issue is the controversial issue of trustee shopping with price cutting and arguably pressure to cut service and due diligence. While cast by some as a market competition issue, it seems that the issue involves one directly implicating ethics and professional practice. It is also closely tied to how insolvency professionals advertise for or portray their services. A cursory examination of television and yellow-page ads reveals that many ads do give the impression that the trustee is there to help the debtor. There are no statutory requirements to disclose the trustee's obligations to creditors in their public advertising, something that could easily be codified. In some cases, the ads are not very professional, and while unfortunate for the profession's image, this seems less of a concern than the impression of whom the trustee will represent. The ads may also contribute to trustee shopping, but the concern with this should not be the shopping, but rather, how to protect the integrity of the services delivered by trustees in the bankruptcy system. It may be that the Superintendent should have the authority to approve format of advertising, including the appropriate caution and disclaimers.

Amendments to the *BIA* in 1997 gave trustees the power to recommend terms of discharge that could require payment of up to 12 additional monthly contributions for bankrupts with surplus income.[121] In 2001, terms of discharge were set in about 7% of cases, something that the PITF concluded was too discretionary. The discretion problem identified was that debtors would shop around for trustees that would not require extra payments, resulting in loss of business to trustees and create incentives to not track assets and increase the contributions to the estate for the benefit of creditors.[122] The PITF recommended codifying the approach to this issue by proposing that trustees be able to recommend 12 additional months of surplus income payments made to the estate before bankrupts with surplus income are discharged. This recommendation would affect 15% of bankrupts, with the criteria to determine the number and amount of payments to be established by the OSB.[123]

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[121] s. 170.1, *BIA*; Directive 12 *Terms of Discharge* at para. 5.

[122] PITF Report, *supra*, note 96 at 45.

[123] *Ibid.* at 46.

While consumer debtors are primarily the most economically and socially disadvantaged people, as indicated by the lack of surplus income for the vast majority, personal bankruptcy is no longer confined to this class of people (if it ever was). Increasingly dentists, doctors and other professionals are going through the bankruptcy process. While they may be seriously over-leveraged in their credit arrangements, their capacity to make surplus payments is measurably greater because their going forward income earning capacity is large. In such case, surplus payments make a great deal of sense and the trustee is not facing the same ethical issue as for the debtor with marginal surplus income who really may be deprived of a fresh start to his or her financial affairs. Where such arrangements are prejudicial to the fresh start of the bankrupt, the trustee may have a conflict in pressing for such agreements and there should be a mechanism that serves as an accountability check on post-discharge arrangements if they are allowed under the amended *BIA*. Information on the scope of income and economic position of the 15% with surplus income is sparse and leaves the public with the impression of debtors being seriously prejudiced by these policy recommendations. That may be the case, but in the absence of data, one cannot have a fully informed public policy debate.

IV. Conflicts Requirements in the U.S. Bankruptcy System

The United States casts a much broader net over professionals and perceived conflicts of interest when engaging insolvency professionals.[124] A brief review highlights the differences in Canadian

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[124] *US Code Collection*, Title 11, Chapter 3, Subchapter II, Section 327 specifies:

Sec. 327 – Employment of professional persons

> (a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one ore more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.
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> (b) If the trustee is authorized to operate the business of the debtor under section 721, 1202, or 1108 of this title, and if the debtor has regularly employed attorneys, accountants, or other professional persons on salary, the trustee may retain or replace such professional persons if necessary in the operation of such business.
>
> (c) In a case under chapter 7, 12, or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.

and U.S. regulation of conflicts. The U.S. *Bankruptcy Code* specifies that the trustee can employ professionals to assist in carrying out its duties if they do not hold an interest adverse to the estate and are disinterested persons.[125] Disinterested is defined as a list of people and professionals, including investment bankers for any outstanding security, attorney under specified conditions, and persons that do not have an interest that is materially adverse to the interest of the estate or of any class of creditors or equity security holders by reason of any direct or indirect relationship with, connection with, or interest in the debtor.[126] Under Chapter 7 or 11 of the U.S. *Bankruptcy Code*, a person is not disqualified solely because they have acted for a creditor, unless there is an objection by another creditor or the U.S. trustee and the court finds there is an actual conflict of interest.[127] The language used is "best interest of the estate".

> (d) The court may authorize the trustee to act as attorney or accountant for the estate if such authorization is in the best interest of the estate.
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> (e) The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate; and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.
>
> (f) The trustee may not employ a person that has served as an examiner in the case.

Given that U.S. counsel examines pre-filing transactions, with a view to any potential misconduct, there is a perceived serious conflict of interest or lack of "disinterestedeness". This may stem in part from the notion of the Debtor in Possession in the U.S. *Bankruptcy Code*, where notionally a separate entity is formed that takes control of the debtor corporation during the reorganization. Thus, there is need for new counsel that can make a dispassionate investigation of the debtor's financial and other activities pre-filing.

[125] Section 327, Title II, c. 3, subchapter II.

[126] *Ibid.* Section 14 specifies: "disinterested person" means person that:

> (A) is not a creditor, an equity security holder, or an insider;
>
> (B) is not and was not an investment banker for any outstanding security of the debtor;
>
> (C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale or insurance of a security of the debtor;
>
> (D) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor or of an investment banker, specified in subparagraph (B) or (C) of this paragraph; and
>
> (E) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph, or for any other reason.

[127] Section 327, *supra*, note 124 at subsection (c).

in the United States, there has been some suggestion that the disinterestedness test is too high a threshold that unnecessarily prevents some firms from acting in restructuring matters and that the more appropriate threshold should be that of adverse interest, defined as an actual conflict of interest.[128] One of the conditions of appointment in the U.S. is that the insolvency or accounting professional must disclose all of the person's connections with the debtor, creditors, any other party with an interest, their respective attorneys and accountants, the United States Trustee, or any person employed in the Office of the United States Trustee.[129]

In Canada, the Senate Committee recommended increased codification, which may ultimately contain some elements of the U.S. approach. The U.S. bankruptcy rules provide for a highly

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[128] The *Restatement (Third) of the Law Governing Lawyers* specifies that: "A conflict of interest is involved if there is a substantial risk that the lawyer's representation of the client would be materially and adversely affected by the lawyer's own interest or by the lawyer's duties to another current client, a former client, or a third person." RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 2021 (Proposed Final Draft No. 1, 1996), discussed in Arthur J. Gonzalez, "Conflicts of Interest and Other Ethical Issues Facing Bankruptcy Lawyers: Is Disinterestedness Necessary to Preserve the Integrity of the Bankruptcy System?", (1999) 28 Hofstra L. Rev. 67.

[129] Fed. R. Bankr. P. 2014, Employment Issues, Section 3-6.1.1. Rule 2014, entitled: "Employment of Professional Persons" provides:

> (a) APPLICATION FOR AN ORDER OF EMPLOYMENT. An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to § 327, § 1103, or §1114 of the Code shall be made only on application of the trustee or committee. The applications shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States trustee. The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangements for compensation, and, to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. The application shall be accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.
>
> (b) SERVICES RENDERED BY MEMBER OR ASSOCIATE OF FIRM OF ATTORNEYS OR ACCOUNTANTS. If, under the Code and this rule, a law partnership or corporation is employed as an attorney, or an accounting partnership or corporation is employed as an accountant, or if a named attorney or accountant is employed, any partner, member, or regular associate of the partnership, corporation or individual may act as attorney or accountant so employed, without further order of the court.
>
> ....Rule 2014(a) does not expressly require supplemental or continuing disclosure. Nevertheless, section 327(a) implies a duty of continuing disclosure, and requires professionals to reveal connections that arise after their retention....[This] [c]ontinuing disclosure [requirement] is necessary to preserve the integrity of the bankruptcy system by ensuring that the trustee's professionals remain conflict free.

codified regime of what constitutes a conflict or perceived conflict of interest. Adding another layer to these rules are the new statutory requirements regarding auditing and accounting services much earlier in the firm's financial life cycle, as enacted under the *Sarbanes-Oxley Act*.

A. The *Sarbanes-Oxley Act* and Conflicts Issues

The U.S. response to recent corporate scandals had been to substantially tighten rules relating to audit and non-audit services, which in turn have an impact on the insolvency professionals involved in a U.S. bankruptcy proceeding. The statute applies to Canadian companies listed on U.S. exchanges; hence this prohibition on acting may determine the "auditor as monitor" issue in Canada for the large SEC registered public audit companies.

The *Sarbanes-Oxley Act* and accompanying SEC Regulations limit the non-audit services the firm can provide its audit clients.[130] It requires pre-approval by the audit committee of all services provided by the independent auditor. It prohibits an audit firm from providing any of the non-audit services expressly enumerated in the *Act*, as well as those that may later be added by SEC regulation.[131] These services have been viewed as impairing auditor independence. It also makes all non-audit services that are greater than 5% of the annual total fees to an audit firm subject to pre-approval of the client corporation's audit committee.[132] The *Sarbanes-Oxley Act* attempts to reduce auditor "capture" or shirking by the client's management by prohibiting the same audit partner from supervising the client's audit for more than 4 years in a row, imposing new rotation requirements.[133] Finally, the *Act* requires that the auditor disclose discussions with management concerning its critical accounting policies, alternatives to those policies and the impact of those alternative accounting treatments, and other material written information to the board of directors' audit committee.[134] This last provision is included to further the second principle in the *Sarbanes-Oxley Act*, that of creating a federal duty of care for the board of directors and in particular, its audit committee. The *Sarbanes-Oxley Act* specifies that the corporation's external auditor will report audit information directly to the audit committee, not to officers of the corporation. The audit committee has direct oversight responsibilities, and there

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[130] Tax services do not impair independence if a pre-approval process has been followed.

[131] *Sarbanes-Oxley Act*, 116 Stat. s. 201.

[132] *Sarbanes-Oxley Act*, 116 Stat. s. 202.

[133] *Sarbanes-Oxley Act*, 116 Stat. s. 203.

[134] *Sarbanes-Oxley Act*, 116 Stat. s. 204.

are new requirements for enhanced disclosure of fees paid to auditors for both audit and non-audit services.

In thinking about the implications of the *Sarbanes-Oxley Act* for Canadian professionals, it is important to note that the capital structure of Canadian corporations differs substantially from that in the United States, and hence the governance challenges differ. Of those companies listed on the TSX index, a majority have a single shareholder with legal control and more than three-quarters of the companies have a single shareholder or a group of three or less shareholders with either legal control or effective control of the corporation.[135] Only 14% of the companies on the TSX 300 were widely held, and of all publicly traded companies on Canada's exchanges only 5.4% are widely traded and have significant institutional shareholder holdings.[136] Directorships are also very interconnected, with a high proportion of directors having multiple directorships.[137] Notwithstanding differences in capital structures, *Sarbanes-Oxley* will apply to Canadian corporations that sell their securities in U.S. markets and are listed on U.S. stock exchanges. Relatively few Canadian companies are listed in U.S. stock exchanges (an estimated 177 companies) and thus subject to the *Sarbanes-Oxley Act*'s requirements, although those listed are among the largest of Canada's corporations.[138]

Post Enron, the Toronto Stock Exchange (TSX) has issued proposed disclosure requirements and amended voluntary guidelines recommending that audit committees should be composed only of unrelated directors and that corporations adopt a charter that sets out the audit committee's roles and responsibilities.[139] The guidelines suggest that all members on the audit committee should be financially literate with at least one member having accounting or related

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[135] Ronald Daniels & Jeffrey MacIntosh, "Towards a Distinctive Corporate Law Regime" (1991) 49 Osgoode Hall Law Journal 893 at 884.

[136] Of the remainder, 59.4% were infrequently traded and 35.3% traded at a moderate frequency, *ibid.* at 877.

[137] Ronald B. Davis, "Fox in S-OX North, A Question of Fit: The Adoption of U.S. Market Solutions in Canada" forthcoming, *Stetson Law Review*, 2004. Ronald J. Daniels & Paul Halpern, "Too Close for Comfort: The Role of the Closely Held Public Corporation in the Canadian Economy and the Implications for Public Policy", (1995-96) 26 *Canadian Business Law Journal* 11. The applicable figures were 28.9% of directors in Canada had two or more appointments as directors, while the comparable percentage in the U.S. was 18.2%.

[138] Christopher C. Nicholls, *Canadian Response to Sarbanes-Oxley* <University of Toronto Capital Markets Institute> (last updated 2003, January), at 9 states that only 177 of Canada's 4,000 publicly traded companies are interlisted on U.S. stock exchanges.

[139] "Unrelated director" is defined as a director who is independent of management, and is free from any interest and any business or other relationship which could, or reasonably be perceived to, materially interfere with the director's ability to act with a view to the best interests of the company, other than interests and relationships arising from shareholding. *TSX Company Manual*, s. 472, Corporate Governance Guidelines, http://TSE.com.

financial expertise.[140] The TSX guidelines are voluntary, not mandatory and hence to date, Canada has not followed the United States in codifying these requirements.

In contrast to the approach of Canadian regulators to governance, the U.S. *Sarbanes-Oxley Act* and new guidelines by the NYSE are mandatory. The *Sarbanes-Oxley Act* utilizes the power to prohibit stock exchanges from listing the stock of a non-compliant company as the means to obtain compliance with its corporate governance requirements. In order to comply, a corporation's board of directors' audit committee must assume responsibility for the appointment of the auditors, the supervision of the audit process and the auditor must report directly to the audit committee. In addition, *Sarbanes-Oxley* specifies that the audit committee must be composed of independent directors and provides a definition of independence that prohibits any financial compensation to the director from the corporation other than the normal directors' fees. The audit committee must be provided with the power to engage independent advisors, and the corporation must provide it with sufficient funds to pay the audit firm and any advisers engaged. Finally, the audit committee must establish procedures for dealing with complaints about accounting or audit matters and the means by which corporate employees can contact it anonymously and in confidence to complain about dubious accounting practices.[141] Corporate officers are responsible for ensuring that the corporation has a set of internal controls that will provide them with material information about the corporation and its subsidiaries and for verifying that the controls are effective within 90 days of submitting a periodic report required under securities legislation. They must also disclose any weaknesses in the internal controls revealed by their verification testing, and any fraud they may have discovered to the corporation's auditors and the audit committee. The rigid codification of these standards suggests that accounting firms will be seriously limited in performing insolvency services for the debtor, where there are prior dealings. Even where there is no technical conflict, clients may choose to avoid any perception of conflict.

A key issue is whether or not the substantial costs of compliance with *Sarbanes-Oxley* type rules can be justified in Canada's capital markets. Those who favour harmonization of Canada's regulations with those of the U.S. suggest that it will meet investors' (including creditors') concerns about regulatory weaknesses and combat inappropriate incentives that if left unchecked

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[140] The Practice Note states that an acceptable definition of financial literacy is the "ability to read and understand a balance sheet, an income statement and a cash flow statement". An acceptable definition of accounting or related financial expertise" is the ability to analyse and interpret a full set of financial statements, including notes, in accordance with GAAP. *Ibid.* at section 473(12), Guidelines.

[141] *Sarbanes-Oxley Act*, 116 Stat. s. 301; the *Sarbanes-Oxley Act* also establishes civil protections for whistle blowers who lose their jobs or are penalized for blowing the whistle with respect to federal securities legislation violations *Sarbanes-Oxley*, 116 Stat. s. 806, as well as increasing the criminal penalties for retaliation against whistle blowers. *Sarbanes-Oxley*, 116 Stat. s. 1107.

might lead to future financial scandals in the Canadian market.[142] Those who oppose wholesale harmonization suggest that any Canadian regulatory initiative is premature because U.S. implementation regulations must still be promulgated; there are problems of fit with Canada's different size/control structures; and that a rules based approach might undermine the efforts of Canadian regulators to create a "culture of compliance" in Canada's corporate governance and securities markets.[143] How this debate is ultimately resolved will influence how debtor corporations perceive conflicts and the consequent engagement of insolvency professionals.

In both Canada and the United States, public company accounting oversight boards have been created to protect interests of the investing public and restore market confidence. In the United States, the *Sarbanes-Oxley Act* removes the accounting profession's self-regulation over accounting industry standards and gives it to the Public Company Accounting Oversight Board (the "PCAOB") a majority of whose members will not be accountants.[144] Audit firms that wish to continue to audit publicly traded companies must register with the PCAOB, which has the power to regulate accounting industry standards relating to auditing standards, quality control, and ethics for those firms registered with it.[145] In addition, the PCAOB will annually inspect the largest accounting firms' quality control, internal control procedures and it has the power to impose penalties for deficiencies, including the suspension and barring of firms and individuals from public firm auditing.[146] These provisions represent a repudiation of the classic understanding of the "independent" external auditor as a firm whose reputation for quality audits was the service that was being sold in the marketplace.[147] The PCAOB will set both procedural and substantive accounting standards, and verify adherence to these standards through its power to inspect the audit firms. The audit committee, not management, retains and supervises the audit firm, and the audit firm must report to the audit committee, supplanting market forces with strict regulatory control to address the problems of the accounting industry's conflict of interest. *Sarbanes-Oxley* increases the potential penalties for misleading statements about the financial condition of the corporation by increasing the civil and criminal penalties and by requiring these officers to

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[142] Nicholls, *Canadian Response*, *supra*, note 138 at 11.

[143] *Ibid.* at 12.

[144] *Sarbanes-Oxley Act*, 116 Stat, s. 101.

[145] *Sarbanes-Oxley Act*, 116 Stat. ss. 102, 103.

[146] *Sarbanes-Oxley Act*, 116 Stat, s. 104 – 105: among the grounds for suspending individuals and firms is for a failure to supervise those performing audits of public companies, *Ibid.* s. 105(6).

[147] Davis, *supra*, note 137.

disgorge any profits from stock trading or bonuses if misconduct was at the root of any restatement of financial information.

In Canada, a new Canadian Public Accountability Board (CPAB) has been set up, also independent, with representation from the major securities stakeholders. Unlike the U.S., the profession worked with regulators to set the CPAB up as a means to enhance self-regulation and to avoid having further regulation imposed by statute. Thus while the objectives of the Canadian and U.S. moves to public accountability are the same, to enhance the role of accountants as gatekeepers in corporation governance, the strategies deployed are quite different.

The likely impact of these developments in the United States for Canadian insolvency practitioners is not yet clear. What is clear is that the Senate Committee perceived that there are conflicts and ethics issues in Canada that require further codification and future public debate will undoubtedly take place in the shadow of U.S. regulatory changes. The Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals are considering this question in the context of responding to the Senate Committee Report. One of its Working Groups has recommended that any party retained to provide specialized services relating to a *CCAA* proceeding, including lawyers, monitors, accountants, CROs, actuaries, liquidators and appraisers should be approved by the court, on notice, no earlier than four business days after the engagement.[148] It recommended that monitors appointed on an *ex parte* basis would be subject to a statutorily codified come back hearing 4 to 7 days after the appointment so that any parties objecting to the appointment can put their position before the court. The Working Group recommended that in considering whether or not to confirm the appointment of the professional, the court should consider a number of specific factors to determine whether the professional can provide independent advice, including freedom from conflicts of interest and the ability to deal with the rights of all interested parties in a fair and even-handed manner. It recommended that perceived conflicts of interest should be considered a disqualifying fact only if they are severe enough to jeopardize the ability of the proceedings to come to a reasonable and efficient conclusion or if the perceived conflict is severe enough to place the professional in a position where it cannot work in harmony with those it is to represent.[149] It further recommended express disclosure requirements and factors that the court should consider in disqualifying a professional from acting on a particular file. This and a host of other recommendations are aimed at codifying the role of insolvency professionals in both

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[148] Working Group E-Report on Independence Issues/Role of the Monitor, (13 April 2004), on file with The Insolvency Institute of Canada.

[149] *Ibid.*

insolvency and bankruptcy proceedings, proposing more of a principles-based rather than the U.S. rules-based approach. The recommendations will be considered by the IIC and CAIRP in May 2004.

V. Conclusion

As the legislative review process continues, there are a number of questions that need to be resolved in respect of conflicts and perceived conflicts. The first is the auditor/monitor issue and whether the Senate Committee recommendation has finally closed debate on this issue or whether Parliament will consider the issue of the role of monitor on a more fulsome basis.

One question this has raised is whether the *CCAA* should include a general provision specifying that the monitor must be independent or disinterested, or other language that addresses conflicts of interest. If so, how does this mesh with the codes of conduct of the accounting profession as self-regulating? What other guidelines should be adopted to ensure practitioners fulfil their duties with a high level of integrity? What are the public policy goals that codifying is aimed at achieving? Is it sufficient that creditors consent to multiple roles of a professional, such as privately appointed receiver and court-appointed trustee? Even where parties consent to insolvency professionals acting in multiple roles, there may be a further concern that fiduciaries must be held to a stricter standard than the morals of the marketplace.[150]

Another issue is whether or not the appointment process should change. Currently, the monitor is appointed by the debtor and sanctioned the court in the initial Stay Order, often on an *ex parte* basis with little or no notice to creditors. Should there be a requirement that the debtor first seek the input or approval of senior secured creditors? Could such a requirement prejudice the less sophisticated creditors such as employees or trade suppliers? Does the current system, which provides a come back clause, still provide too great a hurdle for creditors to come before the court with a motion to set aside the appointment of the monitor, particularly given the very time sensitive nature of a *CCAA* proceeding? Instead, should there be a process shortly after the initial appointment for stakeholders to ratify the appointment, as the IIC/CAIRP Working Group has recommended? Should the *BIA* and *CCAA* be brought in line with one another, in terms of also rethinking the appointment of the trustee in a proposal proceeding? Would this unnecessarily add time and cost for questionable benefits? Many of these questions go back to the discussion of what is the role of the monitor in a *CCAA* proceeding and a trustee in a *BIA* proposal

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[150] *Meinhard* v. *Salmon*, 249 N.Y. 458 (1928) at 464.

proceeding. Are there particular harms or potential conflicts of interest in either the appointment process or in the scope of duties that should be addressed through statutory reform?

One question that arises with the legislative reform process is what will be the scope of disclosure required in respect of possible conflicts of interest. This question has both a temporal and materiality aspect to it. The question for Canada's review of the legislation is how far back must any disclosures go and what is the scope of relationships that must be disclosed? Should there be an exclusion for *de minimus* relationships or should there be a standard of materiality? Should the monitor be left with the decision about what is material on the basis of professional assessment and leave any complaints to self-regulation or should this be codified in the statutes?

The Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals in their Joint Task Force Report to the Senate Committee on review of the *BIA* and the *CCAA* recommended that monitors be given the power to examine and act on reviewable transactions.[151] While not expressly addressed by the Senate Committee in its recommendations, further consideration of this recommendation by Parliament needs to address the risks posed by placing a monitor that has a prior accounting or audit relationship with the debtor in a position of investigating pre-filing claims. The issue is whether this creates a prohibition on acting at all, or whether it is possible to "contract out" this part of the monitor's duties to a truly independent insolvency professional.

Finally, while the rules of professional conduct by the CAIRP are thoughtful, it may be time to revisit them in order to verify that they are still timely and appropriate. For example, rule 12 specifies that the professional shall not disclose confidential information concerning a professional engagement unless required to do so by law.[152] It is unclear that this rule adequately addresses the complex confidentiality issues faced by insolvency professional engaged in multiple roles. There may also need to be some clarification of any differences between rules and general principles.

This discussion has raised more questions than answers. While the profession on both the commercial side and the personal side is grappling with both conflicts questions and the question of public perception, there are not easy answers. In part, this is a function of the very role of insolvency professionals, which does not fit easily either into the pure advocacy role or the disinterested court officer role. On the personal side, trustees deal with individuals in extremely

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[151] The Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals. *Joint Task Force on Business Insolvency Law Reform: Report*. (March 15, 2002) at 23.

[152] CAIRP Rules of Professional Conduct, *supra*, note 8 at 1.

vulnerable situations, who have few resources to work through their financial distress. Trustees play multiple roles that are challenging and which require further conceptualization if we are truly to promote an accessible and fair system. There should be a mechanism in place to ensure that personal debtors fully understand the role and obligations of the trustee, with communication regarding those duties sensitive to issues of race, class and English or French as the debtor's second language. Where the insolvency professional is acting for multiple parties, this needs to be made very transparent, including signalling the limits of this multiple role in terms of lack of confidentiality, the course of action in the event of conflict of interest, and advising parties to seek independent legal advice. Commercial insolvency practitioners also face challenges in terms of whom they represent and the conflicts inherent in undertaking multiple roles. There is a tension between the evolving role of the monitor or proposal trustee and the need to act as court-appointed officer in representing and considering the interests of all stakeholders. Issues of public confidence and public trust are met only through continued public policy debate about the objectives of the system, the integral role of insolvency professionals in that system and a willingness to address the most problematic challenges in terms of professional ethics and conflicts of interest.