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After *Indalex*: Pension Claims Under the New *CCAA*

By Sam Babe

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On February 1, 2013, the Supreme Court of Canada (the "SCC") released its long-awaited decision in *Sun Indalex Finance, LLC v. United Steel Workers*[1] ("*Indalex*"). By a five to two majority, the SCC allowed the appeal from the 2011 decision of the Ontario Court of Appeal (the "OCA") which had created so much uncertainty about the relative priorities of debtor-in-possession ("DIP") lending charges and pension claims in *Companies' Creditors Arrangement Act* (the "*CCAA*") proceedings. The SCC was unanimous in holding that the deemed trust for pension claims created by section 57 of the *Pension Benefits Act* (Ontario) (the "*PBA*"), which deemed trust is elevated to priority status by the operation of subsection 30(7) of the *Personal Property Security Act* (Ontario) (the "*PPSA*"), had survived into the commencement of Indalex's *CCAA* proceeding but then had its priority reversed by the court-ordered charge in favour of the DIP lender. The SCC held that a DIP charge in a *CCAA* proceeding has the same paramountcy over a conflicting priority scheme under provincial legislation as if the court-ordered DIP Charge priority scheme had been prescribed by the *CCAA* itself.

Although the SCC's decision gives some comfort to DIP lenders in *CCAA* proceedings, it actually did not provide that much practical clarity. On the one hand, DIP lenders had already successfully worked around the OCA's Indalex decision by seeking explicit paramountcy rulings in *CCAA* DIP-charge orders[2]. On the other hand, would-be DIP lenders will still have to make sense of certain statements made by the SCC about giving notice before seeking a DIP charge and will have to determine how to time DIP advances if, due to such new notice requirements, the DIP charge cannot be obtained on the first day of the *CCAA* proceedings. The would-be DIP lender in that position shares the uncertainty of any other creditor who has to rely on contractual security rather than a court-ordered charge. And, unfortunately, contractually secured creditors get neither comfort nor certainty from the SCC's ruling.

PBA Deemed Trust Expanded

Secured creditors without a DIP charge get no comfort because the SCC held that the *PBA* deemed trust survives a *CCAA* filing, thus priming non-DIP charge secured claims in respect of proceeds of current assets by the operation of subsection 30(7) of the *PPSA* which elevates *PBA* and *Employment Standards Act* (Ontario) (the "*ESA*") deemed

1 *Indalex Inc., Re*, (1996) 2013 SCC 6, 96 C.B.R. (5th) 171, 354 D.L.R. (4th) 581 (S.C.C.); reversing *Indalex Ltd.*, Re (2011), 331 D.L.R. (4th) 352, 75 C.B.R. (5th) 19, 104 O.R. (3d) 641, 2011 ONCA 265 (Ont. C.A.); reversing *Indalex Ltd., Re* (2010), 2010 ONSC 1114 (Ont. S.C.J. [Commercial List]); and reversing in part *Indalex Ltd., Re* (2011), 81 C.B.R. (5th) 165, 2011 ONCA 578 (Ont. C.A.)

2 See, for example, *Timminco Ltd., Re*, (2012) 2012 ONSC 506, 85 C.B.R. (5th) 169 (Ont. S.C.J. [Commercial List]).

trust claims above other secured claims. Moreover, secured creditors would be primed to a greater extent than previously thought because the SCC also expanded the scope of the *PBA* deemed trust. *PBA* subsection 57(4) creates a deemed trust for employer contributions "accrued to the date of the wind up but not yet due". The SCC majority held that, although the subsection 57(4) deemed trust only applies to *CCAA* company's pension plan if the plan's wind-up had already commenced prior to the *CCAA* filing, in such circumstance, the subsection 57(4) deemed trust extends to all amounts that are determined to be owing by the employer up to the date of wind-up (even if such amounts are not determined until a later date) and not just amounts that could be determined on the date of wind-up. This expansion of the *PBA* deemed trust to cover wind-up deficiencies presents a problem for lenders (and therefore companies who need credit), not just because of the potentially large quanta of such newly-prioritized wind-up deficiencies, but also because such liabilities will not be calculated until some undetermined time, after wind-up has begun, by an actuary who will employ art as much as science to do so – and then remain subject to recalculation thereafter. The calculation of a pension plan's wind-up deficiency will depend on, among other things, choices the plan beneficiaries can only make after the wind-up has commenced and the actuary's assumptions. It will then fluctuate over the five-year period the employer has to satisfy the wind-up deficiencies due to changes in market and other assumptions. So, even if the amounts in question were manageable, it could be practically impossible for a lender to maintain reserves to deal with such liabilities with any reasonable precision. As SCC Justice Cromwell (dissenting on this point) put it in his *Indalex* judgment:

> " … extending the deemed trust protections to the wind-up deficiency might well be viewed as counter-productive in the greater scheme of things. A deemed trust of that nature might give rise to considerable uncertainty on the part of other creditors and potential lenders. This uncertainty might not only complicate creditors' rights, but it might also affect the availability of funds from lenders. The wind-up liability is potentially large and, while the business is ongoing, the extent of the liability is unknown and unknowable for up to five years. Its amount may, as the facts of this case disclose, fluctuate dramatically during this time. A liability of this nature could make it very difficult to assess the creditworthiness of a borrower and make an appropriate apportionment of payment among creditors extremely difficult."[3]

No Clarity on Impact of New *CCAA*

Secured Creditors without a DIP charge also get no certainty from the *Indalex* decision because the SCC applied the *CCAA* without its material 2009 amendments. The amendments enacted in September 2009 after the start of, and thus not binding on, the Indalex *CCAA* proceedings include a number of provisions aimed at giving new protection to pension claims. Section 6 of the *CCAA*, which sets out certain pre-conditions for court sanctioning of a plan of compromise or arrangement, now prohibits a court from sanctioning a *CCAA* plan unless the plan ensures payment of certain amounts to pension plans. These pension amounts are limited in subsection 6(6) to (i) unpaid amounts deducted from payroll, (ii) unpaid normal costs contributions, and (iii) any unpaid defined employer contributions. Because underfunded amounts are limited to unpaid normal cost contributions, the effective priority the *CCAA* now gives to pension claims is far narrower in scope than the priority (by operation of *PPSA* subsection 30(7)) under the *PBA* deemed trust, which covers all unfunded pension liabilities including special payments (going concern unfunded liabilities and solvency deficiencies) and wind-up deficiencies. In its language, *CCAA* subsection 6(6) largely mirrors the language of subsection 60(1.5) of the *Bankruptcy and Insolvency Act* (the "*BIA*") which imposes similar requirements when a court is approving a *BIA* proposal. *CCAA* subsection 6(6) also follows closely the language in sections 81.5 and 81.6 of the *BIA* which create super-priority charges for certain pension claims in bankruptcy and receivership, and has the same effect as those *BIA* provisions.

More pertinent to the facts in *Indalex*, the 2009 *CCAA* amendments also include the new section 36 provisions governing going-concern sales in *CCAA* proceedings. As a pre-condition to court approval of such a sale, subsection 36(7) requires payment of "the amounts that would have been required under paragraphs 6(4)(a) and (5)(a) if the court had sanctioned the compromise or arrangement". Paragraph 6(5)(a) of the *CCAA* requires payment of the same types and amounts of pre-filing wage arrears as are given priority in bankruptcies and receiverships (by operation of sections 81.3, 81.4 and 136 of the *BIA*) together with all post-filing wage arrears. A quandary arises, however, because there is no paragraph 6(4)(a) in the *CCAA*[4]. Subsection 36(7) of the *CCAA* and the parallel subsection 65.13(8) of the *BIA* were originally introduced in 2007 by Bill C-12[5]. The legislative summary for Bill C-12 described the effect of subsection 36(7) of the *CCAA* (and subsection 65.13(8) of the *BIA*) as follows:

> " … in the case of a debtor that is an employer, the court may only grant an authorization to sell or dispose of the assets if it is satisfied that

3 *Indalex* note 1 *supra*, at paragraph 177.

4 The closest thing to a paragraph 6(4)(a) is subsection 6(4), which requires, as a condition to court sanction of a plan, that crown claims assessed post-filing (including, without limitation, for source deductions) be satisfied.

5 Bill C-12 would be enacted as *An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada*, 2005, S.C. 2007 C. 36.

> the debtor can and will make any payments in respect of unpaid wages and unremitted pension plan contributions that would have been required in order to obtain court approval of the reorganization"[6]

The legislative summary then immediately goes on to state, in a footnote:

> "(28) It should be noted that there is a small drafting error under the proposed section 36(7) of the *CCAA*. That section reads: "The court may grant the authorization only if the court is satisfied that the company can and will make the payments that would have been required under paragraphs 6(4)(a) and (5)(a) if the court had sanctioned the compromise or arrangement" (emphasis added). Subsections 6(4)(a) and 6(5)(a) of the *CCAA*, as enacted by Chapter 47, are the provisions that require the reorganizing debtor to meet its obligations with respect to unpaid wage claims and unremitted pension plan contributions. However, these provisions are renumbered under clause 106 of Bill C-12 as paragraphs 6(5)(a) and 6(6)(a). There is no 6(4)(a)."

It thus appears that the reference in section 36(7) of the *CCAA* to the provisions in section 6 of the *CCAA* protecting wage and pension claims was not amended to reflect the renumbering of those section 6 provisions, effected by Bill C-12.

The account given in the Bill C-12 legislative summary is the only plausible explanation for the reference, in *CCAA* section 36(7), to the non-existent paragraph 6(4)(a) and the lack of a reference to 6(6)(a), where the latter would be necessary to protect pension amounts in the case of a going-concern sale. As it stands, with the typographical error in place, the *CCAA* going-concern sale provisions are inconsistent with the *BIA* provisions governing going-concern sales in proposal proceedings (specifically subsection 65.13(8)) which do require payment in a going-concern sale of the same pension amounts as must be satisfied in a proposal (namely the same amounts as are protected in bankruptcies and receiverships by operation of sections 81.5 and 81.6 of the *BIA*, along with any post-filing wage arrears)[7]. If this inconsistency between treatment of pension claims in *CCAA* proceedings and their treatment in *BIA* proposal proceedings, receiverships and bankruptcies actually was intentional on the part of Parliament, it would fly in the face of one of the over-arching purposes of the 2009 amendments to the two statutes, namely harmonization of priority regimes.

For the above reasons, the remainder of this article is based on the assumption that: (i) the courts will interpret the references to paragraphs 6(4)(a) and 6(5)(a) in subsection 36(7) of the *CCAA* as actually references to paragraphs 6(5)(a) and 6(6)(a); and (ii), in its upcoming 5-year review of the *CCAA*, Parliament will correct the typo mentioned in the Bill C-12 legislative summary, so that there is no doubt that 36(7) provides protection for pension claims.

This raises the question of whether, given the protection of pension claims introduced in the new *CCAA*, and given the limited scope of this protection, the *PBA* deemed trust should still be considered to survive a *CCAA* filing. Framed another way: are pension claims against a *CCAA* company protected only by their effective super-priority status under *CCAA* sections 6 and 36(7), or do they also benefit from the priority status accorded by the *PBA* deemed trust and section 30(7) of the *PPSA*? If the *PBA* deemed trust survives to provide additional protection, pension claimants would enjoy priority under section 6 and subsection 36(7) over all secured creditors including any DIP lender, for a sub-set of their claims, and then a second, lower level of priority under the *PBA* and *PPSA* (with respect to proceeds of current assets) over all non-DIP lenders and other non-super-priority creditors. This question was not addressed by the SCC in *Indalex* as there was no discussion in the SCC's judgment about the impact of the 2009 amendments. As discussed below, the legislative process leading to the 2009 amendments was discussed in Justice Deschamps' conclusion, but only as evidence that federal Parliament had considered, but then chose not to expand, the scope of the priority for pension claims.

Intent of New *CCAA* Pension Protections

The protections for wage and pension claims in *CCAA* section 6 were first introduced in 2005 by Bill C-55[8]. Industry Canada's clause-by-clause analysis of Bill C-55 gives the following rationale for these new protections (referring to subsections 6(4) and 6(5), which, as discussed above, eventually would become 6(5) and 6(6), respectively):

> " … The intention of the reform is to ensure that the treatment of certain claims be similar in both the *CCAA* and the *BIA* to prevent forum shopping to defeat these interests, which are protected for public policy reasons. Concurrent reforms to the BIA require that a court's ability to sanction a plan be limited to an extent to ensure that the treatment of certain creditor groups be the same in both the BIA and *CCAA*.
>
> …
>
> Subsection (4) prohibits the court from sanctioning

6 See: http://www.parl.gc.ca/Content/LOP/LegislativeSummaries/39/2/c12-e.pdf at page 23.

7 It is also notable that *BIA* subsection 65.13(8) does not require payment of amounts covered by BIA subsection 60(1.2), being the analogue to *CCAA* subsection 6(4).

8 Bill C-55 would be enacted as *An Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts*, S.C. 2005 C. 47.

a plan of arrangement or compromise unless the plan requires the payment of all outstanding unpaid wage claims of employees and former employees, subject to monetary limits in the BIA.

A concurrent reform in the *BIA* to enhance the protection of wage earners in respect of unpaid wages is reflected in the *CCAA* to ensure equal treatment of workers under both statutes. By prohibiting a court from sanctioning a plan unless the plan requires the payment of unpaid wages, the reform ensures equal treatment of wage earners whether the employer becomes bankrupt, files a proposal under the *BIA* or enters *CCAA* proceedings.

Subsection (5) prohibits the court from sanctioning a plan of arrangement or compromise unless the plan requires the payment of specific pension obligations, enumerated in the subsection, outstanding at the date of the hearing to sanction the plan.

Subsection (6) provides that, notwithstanding subsection (5), the court may sanction a plan if the parties to the pension plan and the relevant pension regulator agree to alternate financing obligations.

Subsections (5) and (6) mirror the reforms in the *BIA*. Effectively, pension obligations will need to be accounted for before a court can sanction a plan.

Pension rights may form a significant portion of a wage earner's compensation from its employer, although it is deferred income. When the employer undertakes a restructuring under the *CCAA*, debts, including those owed to a pension fund, may be compromised. For wage earners, a diminution of pension benefits would have a negative impact on future income levels.

The intention of the reform is to provide a higher priority for unremitted pension contributions. The amounts subject to the provision are (1) contributions deducted from employees' salaries but not remitted to the pension fund, (2) contributions owed by an employer for the cost of benefits offered under the pension plan, excluding amounts payable to reduce an unfunded pension liability, and (3) contributions owed by an employer to a defined contribution plan. Obligations relating to unfunded pension liabilities, including special payments or solvency payments ordered to be paid by a regulator but not remitted to the pension fund, are not intended to be captured by the reform and will not be given a higher priority. If an unfunded pension liability exists and a claim is made, it would be treated as an unsecured debt.

Because court approval is required before a compromise or arrangement is finalized, prohibiting a court from approving it if it does not require the payment of unremitted pension contributions described above effectively grants a super-priority to the pension contribution amounts. The super-priority, however, is limited by the operation of subsection (6).

Subsection (6) provides flexibility to allow for a compromise of pension contribution obligations where the parties agree. It is expected that the provision will be used in limited circumstances where the parties agree to reduce pension benefits, which would reduce the employer's obligations. Requiring full payment of pre-filing contributions would not make sense in that circumstance.

The nature of pension regulation in Canada also affects aspects of the section - pensions may be regulated federally or provincially. The section must capture kinds of pensions described in the federal and provincial legislation. Prescribing pension plans that will be subject to this section provides greater flexibility to ensure that the appropriate pension plans are captured."[9]

Two points (among others) can be drawn from this Industry Canada analysis: (i) the desire for harmonization of priority regimes in bankruptcy, *BIA* proposals and *CCAA* proceedings; and (ii) the expectation that unfunded pension liabilities (not protected by what would become subsection 6(6)) would be treated as unsecured claims. Indeed, for the reasons below, unfunded pension liabilities of a *CCAA* company would have to be treated as unsecured in order to maintain consistency with how they would be treated in a bankruptcy or a proposal.

Treatment of Pension Claims under BIA

Apart from the super-priority status in bankruptcy accorded to particular classes of pension claims by *BIA*

9 See: http://www.ic.gc.ca/eic/site/cilp-pdci.nsf/eng/cl00821.html or http://www.ic.gc.ca/eic/site/cilp-pdci.nsf/vwapj/clXcl124-129EN.pdf/$FILE/clXcl124-129EN.pdf at pages 6 to 7. Industry Canada's clause-by-clause analysis of Bill C-12, which introduced the corresponding protection of wage and pension claims in going-concern sales by the new CCAA subsection 36(7), does not shed further light on the subject, saying only:

> "Subsection (7) is added to ensure that the interests of wage earners are protected, as are the interests of other creditors. By requiring the court to consider the effect of any sale on the rights of those claimants, the risk that a debtor company will engage in a liquidating plan (i.e., a restructuring run with the intention of disposing of all assets) will be removed."

See: http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br01986.html#a87 or http://www.ic.gc.ca/eic/site/bsf-osb.nsf/vwapj/Clause%20by%20Clause%20EN.pdf/$FILE/Clause%20by%20Clause%20EN.pdf section 81.5 (which came into force in July 2008), and the effective super-priority status accorded to the same classes of pension claims in proposal proceedings by *BIA* subsections 60(1.5) and 65.13(8) (which came into force in September 2009), all other pension claims (including those for unfunded liabilities) have only unsecured status in bankruptcies and proposals because:

a. such claims are not recognized as trust claims since, according to case law, *BIA* paragraph 67(1)(a), which excludes assets held in trust from estate property divisible amongst the creditors of a bankrupt, does not extend to assets subject to deemed trusts created by provincial statute (where such deemed trusts do not otherwise have all the attributes of common law trusts)[10];

b. such claims are not recognized as secured claims since, according to case law, the creation of a statutory charge and/or lien in respect of provincial statutory deemed trust amounts does not make the deemed trust claim a secured claim ranking at the top of the *BIA* section 136 priority scheme for distribution of proceeds of a bankrupt's estate [11];

c. such claims are not priority claims because *BIA* section 136 contains no spot in the priority scheme for pension claims; and

d. pursuant to *BIA* subsection 66(1), *BIA* subsection 67(1) (interpreted as it has been by the courts not to apply to statutory deemed trusts) and the section 136 priority scheme both apply to Division I proposals[12].

Because of the limited scope of *BIA* subsections 60(1.5) and 65.13(8), unfunded pension liabilities remain unsecured claims in proposal proceedings, or at least in proposals (since *BIA* subsection 66(1) only speaks of proposals, as it was not amended to reflect the new concept of a going-concern sale in a proposal proceeding). Thus, if the *PBA* deemed trust survives the commencement of a proceeding under the post-September 2009 *CCAA*, and, as a result, claims for unfunded pension liabilities still enjoy priority status, then that would be inconsistent with how such claims are treated in *BIA* proposals (and, possibly, *BIA* proposal going-concern sales).

Reading in Parliamentary Intent to Harmonize

Harmonization of priority regimes in the *BIA* and the *CCAA* was one of the primary stated purposes of the new pension claims provisions. As discussed above, Industry Canada's clause-by-clause analysis of the relevant provision of Bill C-55 stated:

> "The intention of the reform is to ensure that the treatment of certain claims be similar in both the *CCAA* and the *BIA* to prevent forum shopping to defeat these interests, which are protected for public policy reasons. Concurrent reforms to the BIA require that a court's ability to sanction a plan be limited to an extent to ensure that the treatment of certain creditor groups be the same in both the BIA and *CCAA*."

In the SCC's earlier 2010 decision in *Century Services Inc. v. Canada (sub nom Re Ted Leroy Trucking Ltd.)* ("*Ted Leroy*"), where it was held that the *Excise Tax Act* (the "*ETA*") deemed trust for GST was reversed in *CCAA* proceedings, the parliamentary intention to harmonize the priority regimes of the *BIA* and the *CCAA* played a pivotal role in Justice Deschamps' judgment for the majority:

> "23 Another point of convergence of the *CCAA* and the *BIA* relates to priorities. Because the *CCAA* is silent about what happens if reorganization fails, the *BIA* scheme of liquidation and distribution necessarily supplies the backdrop for what will happen if a *CCAA* reorganization is ultimately unsuccessful. In addition, one of the important features of legislative reform of both statutes since the enactment of the *BIA* in 1992 has been a cutback in Crown priorities (S.C. 1992, c. 27,

10 See *GMAC Commercial Credit Corp. - Canada v. TCT Logistics Inc*., (2005) 7 C.B.R. (5th) 202, 74 O.R. (3d) 382 (Ontario C.A.), reversing in part *GMAC Commercial Credit Corp.- Canada v. TCT Logistics Inc*., (2002), 61 O.R. (3d) 85, 36 C.B.R. (4th) 231 (Ont. S.C.J. [Commercial List]) at paragraphs 14 to 17. See also *Continental Casualty Co. v. MacLeod-Stedman Inc*., [1997] 2 W.W.R. 516, 141 D.L.R. (4th) 36 (Manitoba C.A.) wherein a number of the same SCC decisions cited and followed by OCA in *TCT Logistics* were also followed by the Manitoba Court of Appeal in finding that a deemed trust under *The Pension Benefits Act* (Manitoba) did not survive a bankruptcy. See also *Ivaco Inc*., Re, (2006) 25 C.B.R. (5th) 176, 83 O.R. (3d) 108, 275 D.L.R. (4th) 132 (Ontario C.A.), a provincial pension deemed trust case in which the OCA echoed, in *obiter*, the *TCT Logistics* stance on provincial deemed trusts in bankruptcy.

11 In *General Chemical Canada Ltd., Re*, (2006) 22 C.B.R. (5th) 298 (Ont. S.C.J. [Commercial List], the court held that, because the PBA deemed trust itself could not survive in bankruptcy, the creation of a charge and lien in respect of the *PBA* deemed trust was "an indirect attempt by the province to do indirectly what it could not do directly, and to legislate priorities for unpaid pension plan contributions. This is a matter solely within the sphere of federal legislation" (at paragraph 70).

12 Subsection 66(1) reads:

> "66.(1) Act to Apply – All the provisions of this Act, except Division II of this Part, in so far as they are applicable, apply, with such modifications as the circumstances require, to proposals made under this Division."

For application of *BIA* subsection 66(1) to terminate a pension deemed trust under provincial statute see *W.R.T. Equipment Ltd., Re* (2003) 41 C.B.R. (4th) 288 (Sask Q.B.), at paragraph 12:

> " … Absent the application of the provisions of the BIA to an employer it is clear that an employer's indebtedness to an employee pension plan does give the pensioners preferred creditor status by virtue of s. 43(3) of *The Pension Benefits Act, 1992*. With the intervention of the BIA, and proceedings under that Act, including the presentation of a Proposal, a combination of s. 66(1) and s. 67(2) of the Act as judicially interpreted results in another conclusion (see *Continental Casualty Co. v. MacLeod-Stedman Inc.* (1996), 141 D.L.R. (4th) 36 (Man. C.A.); *Husky Oil Operations Ltd. v. Minister of National Revenue* (1995), 128 D.L.R. (4th) 1 (S.C.C.)). Provincially created statutory trusts, such as the one created by *The Pension Benefits Act, 1992* are not recognized in bankruptcy, including Proposals submitted under the BIA."

s. 39; S.C. 1997, c. 12, ss. 73 and 125; S.C. 2000, c. 30, s. 148; S.C. 2005, c. 47, ss. 69 and 131; S.C. 2009, c. 33, ss. 25 and 29; see also *Alternative granite & marbre inc., Re*, 2009 SCC 49, [2009] 3 S.C.R. 286, [2009] G.S.T.C. 154 (S.C.C.); *Quebec (Deputy Minister of Revenue) c. Rainville* (1979), [1980] 1 S.C.R. 35 (S.C.C.); Proposed *Bankruptcy Act* Amendments: Report of the Advisory Committee on Bankruptcy and Insolvency (1986)).

24 With parallel *CCAA* and *BIA* restructuring schemes now an accepted feature of the insolvency law landscape, the contemporary thrust of legislative reform has been towards harmonizing aspects of insolvency law common to the two statutory schemes to the extent possible and encouraging reorganization over liquidation (see *An Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts*, S.C. 2005, c. 47; *Gauntlet Energy Corp., Re*, 2003 ABQB 894, [2003] G.S.T.C. 193, 30 Alta. L.R. (4th) 192 (Alta. Q.B.), at para. 19).

…

47 Moreover, a strange asymmetry would arise if the interpretation giving the *ETA* priority over the *CCAA* urged by the Crown is adopted here: the Crown would retain priority over GST claims during *CCAA* proceedings but not in bankruptcy. As courts have reflected, this can only encourage statute shopping by secured creditors in cases such as this one where the debtor's assets cannot satisfy both the secured creditors' and the Crown's claims (Gauntlet, at para. 21). If creditors' claims were better protected by liquidation under the BIA, creditors' incentives would lie overwhelmingly with avoiding proceedings under the *CCAA* and not risking a failed reorganization. Giving a key player in any insolvency such skewed incentives against reorganizing under the *CCAA* can only undermine that statute's remedial objectives and risk inviting the very social ills that it was enacted to avert.

48 Arguably, the effect of *Ottawa Senators* is mitigated if restructuring is attempted under the BIA instead of the *CCAA*, but it is not cured. If *Ottawa Senators* were to be followed, Crown priority over GST would differ depending on whether restructuring took place under the *CCAA* or the *BIA*. The anomaly of this result is made manifest by the fact that it would deprive companies of the option to restructure under the more flexible and responsive *CCAA* regime, which has been the statute of choice for complex reorganizations."[13]

It should be noted, however, that in *Indalex*, Deschamps J. cautioned against making too much of the parliamentary intent to harmonize the *BIA* and *CCAA* priority regimes:

> "49 The Appellants argue that any provincial deemed trust is subordinate to the DIP charge authorized by the *CCAA* order … First, they submit that the *PBA* deemed trust does not apply in *CCAA* proceedings because the relevant priorities are those of the federal insolvency scheme, which do not include provincial deemed trusts …
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> 50 The Appellants' first argument would expand the holding of *Ted Leroy Trucking Ltd., Re,* 2010 SCC 60, [2010] 3 S.C.R. 379 (S.C.C.), so as to apply federal bankruptcy priorities to *CCAA* proceedings, with the effect that claims would be treated similarly under the *CCAA* and the *BIA*. In *Century Services*, the Court noted that there are points at which the two schemes converge:
>
> > Another point of convergence of the *CCAA* and the *BIA* relates to priorities. Because the *CCAA* is silent about what happens if reorganization fails, the *BIA* scheme of liquidation and distribution necessarily supplies the backdrop for what will happen if a *CCAA* reorganization is ultimately unsuccessful. [para. 23]
>
> 51 In order to avoid a race to liquidation under the BIA, courts will favour an interpretation of the *CCAA* that affords creditors analogous entitlements. Yet this does not mean that courts may read bankruptcy priorities into the *CCAA* at will. Provincial legislation defines the priorities to which creditors are entitled until that legislation is ousted by Parliament. Parliament did not expressly apply all bankruptcy priorities either to *CCAA* proceedings or to proposals under the BIA. Although the creditors of a corporation that is attempting to reorganize may bargain in the shadow of their bankruptcy entitlements, those entitlements remain only shadows until bankruptcy occurs. At the outset of the insolvency proceedings, Indalex opted for a process governed by the *CCAA*, leaving no doubt that although it wanted to protect its employees' jobs, it would not survive as their employer. This was not a case in which a failed arrangement forced a company into liquidation under the BIA. Indalex achieved the goal it was pursuing. It chose to sell its assets under the *CCAA*, not the *BIA*.

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13 *Century Services Inc. v. Canada* (*sub nom Re Ted Leroy Trucking Ltd.*), [2010] 3 S.C.R. 379, 72 C.B.R. (5th) 170, 326 D.L.R. (4th) 577 (S.C.C.).

> 52 The provincial deemed trust under the *PBA* continues to apply in *CCAA* proceedings, subject to the doctrine of federal paramountcy (*Crystalline Investments Ltd. v. Domgroup Ltd.*, 2004 SCC 3, [2004] 1 S.C.R. 60 (S.C.C.), at para. 43). The Court of Appeal therefore did not err in finding that at the end of a *CCAA* liquidation proceeding, priorities may be determined by the *PPSA's* scheme rather than the federal scheme set out in the *BIA*."

Although we must, therefore, heed Justice Deschamps' warning that courts cannot read bankruptcy priorities into the *CCAA* at will, the argument being made in this article is that, for the sake of harmony, the *CCAA* can and should be read to be consistent with the priority regime applicable to *BIA* proposal proceedings. That proposition seems a matter of common sense, since the two proceedings serve parallel purposes. It has, of course, already been argued above that subsection 66(1) of the *BIA* imports the bankruptcy priority scheme into *BIA* proposals (and, possibly, *BIA* proposal proceeding going-concern sales). It also has to be noted that, in the passage excerpted immediately above, Justice Deschamps states: "Parliament did not expressly apply all bankruptcy priorities either to *CCAA* proceedings <u>or to proposals under the *BIA*</u>." (emphasis added). This statement was made, however, seemingly in passing, with no acknowledgement or analysis of *BIA* subsection 66(1), nor of any case that applies that section, and therefore has to be given limited weight.

Applying Principle of Implied Exclusion

In addition to the harmonization argument, the argument can be made that the fact that *CCAA* subsections 6(6) and 36(7) give an effective super-priority only to a limited subset of pension claims, implies an exclusion of priority for other types of pension claims, including for unfunded pension liabilities[14]. This argument is bolstered by the fact that it is well documented that claims for unfunded pension liabilities were considered, but rejected, for inclusion in subsections 6(6) and 36(7)[15]. As Justice Deschamps stated in the conclusion of her judgment in *Indalex*:

> "81 There are good reasons for giving special protection to members of pension plans in insolvency proceedings. Parliament considered doing so before enacting the most recent amendments to the *CCAA*, but chose not to (*An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005*, S.C. 2007, c. 36, in force September 18, 2009, SI/2009-68; see also Bill C-501, *An Act to amend the Bankruptcy and Insolvency Act and other Acts* (pension protection), 3rd Sess., 40th Parl., March 24, 2010 (subsequently amended by the Standing Committee on Industry, Science and Technology, March 1, 2011)). A report of the Standing Senate Committee on Banking, Trade and Commerce gave the following reasons for this choice:
>
>> "Although the Committee recognizes the vulnerability of current pensioners, we do not believe that changes to the *BIA* regarding pension claims should be made at this time. Current pensioners can also access retirement benefits from the Canada/Quebec Pension Plan, and the Old Age Security and Guaranteed Income Supplement programs, and may have private savings and Registered Retirement Savings Plans that can provide income for them in retirement. The desire expressed by some of our witnesses for greater protection for pensioners and for employees currently participating in an occupational pension plan must be balanced against the interests of others. As we noted earlier, insolvency — at its essence — is characterized by insufficient assets to satisfy everyone, and choices must be made.
>>
>> The Committee believes that granting the pension protection sought by some of the witnesses would be sufficiently unfair to other stakeholders that we cannot recommend the changes requested. For example, we feel that super priority status could unnecessarily reduce the moneys available for distribution to creditors. In turn, credit availability and the cost of credit could be negatively affected, and all those seeking credit in Canada would be disadvantaged."
>>
>> Debtors and Creditors Sharing the Burden: A Review of the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act* (2003), at p. 98; see also p. 88.)
>
> 82 In an insolvency process, a *CCAA* court must consider the employer's fiduciary obligations to plan members as their plan administrator. It must grant a remedy where appropriate. However, courts should not use equity to do what they wish Parliament had done through legislation."

The implied exclusion rule of statutory interpretation was recently applied (albeit without specific identification as such) by the Supreme Court of Canada in *Re AbitibiBowater*

14 This would be an application of the maxim "*expressio unius est exclusio alterius*" or "the expression of one thing is the exclusion of the other".

15 See, for example, Industry Canada's parliamentary notes on Bill C-55, note 9 supra, as well as the summary of submissions made to the Standing Senate Committee on Banking, Trade and Commerce in its report, *Debtors and Creditors Sharing the Burden: A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act* available at: http://www.parl.gc.ca/37/2/parlbus/commbus/senate/com-e/bank-e/rep-e/bankruptcy-e.pdf .

Inc., where the court held that the limited priority given to environmental claims in new subsection 11.8(8) of the *CCAA* implies an exclusion of any priority for other types of environmental claims and that granting any priority to those other types of claims would be inconsistent with the *CCAA*:

> "32 Parliament recognized that regulatory bodies sometimes have to perform remediation work (see House of Commons, Standing Committee on Industry, No. 16, 2nd Sess., 35th Parl., June 11, 1996). When one does so, its claim with respect to remediation costs is subject to the insolvency process, but the claim is secured by a charge on the contaminated real property and certain other related property and benefits from a priority (s. 11.8(8) *CCAA*). Thus, Parliament struck a balance between the public's interest in enforcing environmental regulations and the interest of third-party creditors in being treated equitably.
>
> 33 If Parliament had intended that the debtor always satisfy all remediation costs, it would have granted the Crown a priority with respect to the totality of the debtor's assets. In light of the legislative history and the purpose of the reorganization process, the fact that the Crown's priority under s. 11.8(8) *CCAA* is limited to the contaminated property and certain related property leads me to conclude that to exempt environmental orders would be inconsistent with the insolvency legislation. As deferential as courts may be to regulatory bodies' actions, they must apply the general rules."[16]

The principle of implied exclusion was also applied by the Supreme Court of Canada in *Ted Leroy* (again without specific identification as such) when it reasoned that since other Crown deemed trusts are explicitly preserved in section 18.3 (now 37) of the *CCAA*, reading in (as the OCA did) a preservation of the *ETA* deemed trust as well, without any explicit statutory language to that effect, would make the *CCAA* internally inconsistent:

> "46 The internal logic of the *CCAA* also militates against upholding the *ETA* deemed trust for GST. The *CCAA* imposes limits on a suspension by the court of the Crown's rights in respect of source deductions but does not mention the *ETA* (s. 11.4). Since source deductions deemed trusts are granted explicit protection under the *CCAA*, it would be inconsistent to afford a better protection to the *ETA* deemed trust absent explicit language in the *CCAA*. Thus, the logic of the *CCAA* appears to subject the *ETA* deemed trust to the waiver by Parliament of its priority (s. 18.4)."

16 *AbitibiBowater Inc., Re*, (2012) 2012 SCC 67, 352 D.L.R. (4th) 399, 95 C.B.R. (5th) 200 (S.C.C.); affirmed *AbitibiBowater Inc., Re* (2010), 68 C.B.R. (5th) 57(Que. C.A.); refused leave to appeal *AbitibiBowater Inc., Re* (2010), 68 C.B.R. (5th) 1 (Que. S.C.).

Conclusion

In conclusion, based on (i) Parliament's intention to harmonize priority regimes in *CCAA* proceedings and *BIA* proposal proceedings and (ii) the fact that Parliament granted limited protection to pension claims in the new *CCAA*, thereby signalling an intention to exclude further protection, this author's view is that the *PBA* deemed trust should no longer survive the commencement of proceedings under the new *CCAA*. As stated above, this conclusion is premised, in the case of going-concern sales in *CCAA* proceedings, on the assumption that: (i) the courts will interpret the references to paragraphs 6(4)(a) and 6(5)(a) in subsection 36(7) of the *CCAA* as actually references to paragraphs 6(5)(a) and 6(6)(a), so that pension claims are protected in a going-concern sale; and (ii), in its upcoming 5-year review of the *CCAA*, Parliament will correct the erroneous reference to 6(4)(a), so that there is no doubt that subsection 36(7) provides protection for pension claims. Neither of those has yet happened, and no court, to the writer's knowledge, has yet ruled on the priority of pension claims subject to a provincial statutory deemed trust in a plan under the post-September 2009 *CCAA*. Until such time, secured claims not backed by a court-ordered charge remain at risk of being primed in *CCAA* proceedings by *PBA* deemed trust claims in respect of pension plans in the process of being wound-up (including claims for unfunded liabilities).

On a final note, if the *PBA* deemed trust does survive a filing under the new *CCAA*, then likely too would survive the *ESA* section 40 deemed trust for vacation pay, which is also backed by a statutory charge and lien over all assets that is elevated to priority status by PPSA subsection 30(7) (in respect of current assets only). As a result, employees would have a second level of priority for any accrued vacation pay not already protected as wages under subsections 6.5(a) and 36(7) of the *CCAA* (which subsections protect all post-filing wages and up to $2,000 per employee for wages accrued in the six months prior to filing). Although the amounts involved in vacation pay arrears may, in many cases, be of lesser magnitude than the potential pension plan liabilities under the newly expanded scope of the *PBA* deemed trust, the survival of the *ESA* deemed trust in *CCAA* proceedings would likely be a more frequent problem for secured lenders. Not every company has a pension plan, let alone a defined plan in wind-up, but almost every company pays vacation pay and will be liable for some amount of accrued vacation pay at any given time. Fortunately, unlike unfunded pension liabilities, a debtor company's accrued vacation pay liabilities should be ascertainable at any given time and therefore something a lender could, in theory, manage with reserves.

Real Estate Development and Investment Companies Having Trouble Finding Shelter Under the *CCAA*

By Ian Aversa and James Desjardins

The *Companies' Creditors Arrangement Act*[1] (the "*CCAA*") is by far the most flexible Canadian law under which a corporation can restructure its business. When compared against the *Bankruptcy and Insolvency Act*[2] (the "*BIA*"), the *CCAA* looks like a blank canvass and lends itself well to invention and mutual compromise. The overarching goal of the *CCAA* is for the debtor corporation to formulate a plan of compromise or arrangement (a "*Plan*") that is approved by the corporation's creditors or to effect a going concern sale, both of which are intended to provide greater value to the creditors than if the debtor corporation were liquidated under the BIA.

Insolvency practitioners seem to prefer using the *CCAA* whenever a debtor corporation satisfies the statutory requirements, the main requirement being that at least $5 million is owed to creditors at the time of the debtor corporation's insolvency – not a high threshold in today's economic environment. However, proceedings under the *CCAA* are expensive and typically involve priority charges over the property of the debtor corporation for professionals, directors and officers of the debtor corporation, and interim financing ("*DIP Financing*"), which can have the effect of eroding creditors' realization. Despite the cost, the *CCAA* has become the go-to choice for debtor corporations that meet the statutory requirements.

Although it is flexible, the *CCAA* is not suitable to all types of businesses that meet its requirements. This reality has recently come to the attention of the Ontario Superior Court of Justice (Commercial List) (the "*Court*") in two cases before Mr. Justice Campbell, *Re Dondeb Inc.* ("***Dondeb***")[3] and the parallel cases of *Romspen Investment Corp. v. Edgeworth Properties, et. al.*[4] and *Re Edgeworth Properties Inc., et. al.*[5] (collectively referred to as "***Edgeworth***").

Both cases share similar facts: the debtor corporations were in the business of real estate development and investment and had several single-purpose subsidiary corporations, each of which owned a discrete piece of real estate. Each piece of real estate was encumbered by at least one mortgage and many were cross-collateralized. Mortgages accounted for the vast majority of the first-ranking secured indebtedness. The debtor corporations sought protection under the *CCAA* and certain of their respective lenders opposed the application on the basis that it would be more advantageous for them to proceed with an orderly sales process under their respective mortgage security.

Dondeb

In *Dondeb*, the debtor corporation sought relief under the *CCAA* to enable a liquidation of its assets and property and that of its subsidiary or affiliated companies. DIP Financing and a charge to secure it, as well an administrative charge to secure the fees and expenses of the professionals involved in the *CCAA* administration, were all sought by the Debtors. The application was opposed by various secured lenders who collectively held approximately 75% of the value of the secured indebtedness. The basis for the opposition was that: (i) the properties would be more appropriately sold under the mortgage security; (ii) the DIP and administration charges unnecessarily burdened the equity of the properties; (iii) the lenders had lost all faith in management and its ability to generate revenue from the real estate; and (iv) no Plan would be realistically accepted by the lenders because there was no underlying business to restructure that would yield greater value for them than through enforcement of their own respective mortgage security.

In the result, the Court refused to grant the debtor corporation relief under the *CCAA* for the simple reason that a successful Plan could not be filed that would receive approval in any meaningful fashion from the creditors. Instead, Campbell J. issued a receivership order under the BIA which, in his view, would achieve an orderly liquidation of most of the properties and protect the revenue from the operating properties with the hope of the potential of some recovery of the debtor company's equity in those properties not "under water". Each property subject to the receivership was compartmentalized such that all of its revenues and expenses were allocated to that particular property. Justice Campbell noted that using the *CCAA* for the express purpose of a liquidation must only be done with caution, particularly when the alternative of an overall less expensive receivership can accomplish the same goal.

Edgeworth

The facts in *Edgeworth* are functionally equivalent to *Dondeb*, except that in *Edgeworth*, only one of the underlying properties was fully developed and there were several thousand secured and unsecured creditors independent of the first-ranking mortgagees. The applicant corporations sought relief under the *CCAA* as a means to provide a single comprehensive forum to address all stakeholder claims. The mortgagees opposed the application on grounds similar to those in *Dondeb*, including a loss in faith of management, there being no viable business to restructure, and the erosion of equity due to the priority DIP Financing and administration charges.

In the result, the Court issued two concurrent orders: one under the *CCAA* to provide a single and comprehensive forum for all stakeholders, and another receivership order under the BIA, which allowed for the appointment of a receiver over the various properties subject to mortgages. However, the outcome of the *Edgeworth* proceedings, which pre-dated the decision in *Dondeb*, was not as effective or efficient as initially envisioned. This result may have weighed in the Court's treatment of *Dondeb* and may signal the Court's total reluctance to grant *CCAA* relief to real estate development and investment companies going forward where their assets are in separate entities and independently secured by different mortgages.

Conclusion

Although attractive for its flexibility, the *CCAA* is not for everyone or every circumstance. Debtor corporations that have disparate real estate development and investment properties in different entities and are encumbered by first-ranking mortgages from several lenders will have difficulty proposing a Plan that is more advantageous than the remedies available to the mortgagees under their respective security. There is little incentive for these lenders with first-ranking security to agree to a Plan that involves the erosion of their security in favour of priority DIP Financing and administration charges. If a debtor corporation is insolvent and not able to complete the development of its real estate properties without further funding, its mortgage lenders may be in a better position by asserting their respective mortgage remedies rather than letting management remain in control of the failed real estate developments under the **CCAA**. It seems, however, that the presence of a vast and diverse group of stakeholders may be another pivotal factor in the Court's determination of whether granting relief under the *CCAA* is appropriate.

1 R.S.C. 1985, c. C-36.

2 R.S.C. 1985, c. B-3.

3 2012 ONSC 6087.

4 *Romspen Investment Corp. v. Edgeworth Properties, et. al.,* 10 November 2011, CV-11-9452-00CL, Receivership Order of Justice Campbell (Ont. Sup. Ct. [Comm. List.]).

5 *Re Edgeworth Properties Inc., et. al.,* 10 November 2011, CV-11-9409-00CL, *CCAA* Order of Justice Campbell (Ont. Sup. Ct. [Comm. List.]).

The Nature and Priority of *Bank Act* Security

By Luciana Amaral*

Bank Act Security

Section 427 of the *Bank Act*[1] provides a comprehensive scheme for the giving of security over certain assets (usually inventory) from certain types of borrowers. The current scheme has existed in substantially similar form since its enactment in 1890.[2] Sections 425-436 of the current *Bank Act* are similar to ss. 82 and 86-90 of earlier Bank Acts and ss. 177-180, 186-187 and 189 of the previous *Bank Act*[3]. This scheme was designed to facilitate the development of the natural resource industry in Canada through secured lending.[4] Courts have held that ss. 425-436, and its predecessors, should be interpreted in a "fair, large and liberal" manner to "best ensure the attainment of the object of the Act."[5]

Requirements for Valid Security

The types of borrowers permitted for the purposes of *Bank Act* security are set out in s. 427(1). It provides that a bank may advance money to, among others, purchasers and dealers in natural products, manufacturers, aqualculturists, and farmers on the security of specific items such as crops and livestock or for the purchase of seed, fertilizer, agricultural implements and equipment.

Bank Act security must be registered in accordance with the provisions set out in ss. 427(4)-(6). Clause 427(4)(a) provides that a "notice of intention" must be registered in the appropriate agency not more than three years before

1 *Bank Act*, S.C. 1991, c. 46 ["*Bank Act*"].

2 *Bank of Montreal v. Innovation Credit Union*, 2010 SCC 47, at para 14.

3 Ian F.G. Baxter, *Law of Banking*, 4th ed. (Toronto: Thomson Canada Limited, 1992) at 105 ["*Law of Banking*"].

4 *Bank of Montreal v. Guaranty Silk Dyeing & Finishing Co.*, [1935] O.R. 493, 1935 CarswellOnt 91 (Ont. C.A.) at para. 24.

5 *Ibid*. at para. 25.

the security is given. Failure to register makes the security void against subsequent creditors or purchasers of the property acting in good faith.

In sum, s. 427 security is generally comprised of four elements:

i. an application for credit;

ii. a notice of intention;

iii. a grant of security of inventory; and

iv. an agreement concerning loans and advances.

The Nature of the Security and its Priority

Subsection 428(1) provides that the giving of security under s. 427 is "the same as if the bank had acquired a warehouse receipt or bill of lading" and has "priority over all rights subsequently acquired in, on or in respect of that property."

The combined effect of ss. 427(1), 427(2) and 428 is to transfer the title of the subject property to the bank, thereby giving the bank all the right and title to the property enjoyed by the previous holder. Where the holder was the owner, then the bank will likely have full title, but where the holder had some lesser interest, then the bank will get that lesser interest.[6] This puts the bank "in the position of a mortgagee holding the legal title subject to the borrower's right of redemption."[7] Accordingly, *Bank Act* security has been commonly compared to a chattel mortgage. In *Royal Bank v. Nova Scotia (Workmen's Compensation Board)*[8] the court described *Bank Act* security in the following manner:

> … the security did not operate to transfer absolutely the ownership in the goods but that the transaction was essentially a mortgage transaction and subject to the general law of mortgages except where the statute has otherwise expressly provided … Section 88 [now 427] set up by the *Bank Act* enables manufacturers, who desire to obtain large loans from their bankers in order to carry on their industrial activities, to give to the bank a special and convenient form of security for the bank's protection in the large banking transactions necessary in the carrying on of industry throughout the country. Until the moneys are repaid, the bank is the legal owner of the goods but sale before default is prohibited and provision is made for the manufacturer regaining title upon repayment. To say that Parliament did not use language to expressly provide that the bank shall have a first lien on the goods is beside the mark. The bank acquires ownership in the goods by the statute.[9]

Priority between *Bank Act* Security and PPSA Security

The most difficult priority problems that courts have struggled to resolve have involved priorities between *Bank Act* security and security under the various provincial personal property statutes.

With respect to determining the priority of *Bank Act* security vis-à-vis a *registered* or *perfected* security under the *Personal Property Security Act* (Ontario)[10], the common law "first in time" rule applies. This means that *Bank Act* security will be subordinate to *PPSA* security if the *PPSA* interest is perfected prior to the bank taking its security interest.[11] The reason for this is twofold. First, as mentioned above, a bank can receive no greater interest in the property than the debtor himself has. Once a *PPSA* security interest in the property is registered, a debtor no longer has unfettered interest with respect to that property. Second, registration provides a way for banks to gain knowledge of the existence of a prior *PPSA* security interest.

With respect to the priority between *Bank Act* security and an *unregistered* or *unperfected PPSA* security, two Supreme Court of Canada decisions concluded that the latter has priority, if obtained prior to the bank's security.[12]

Following these two decisions, there was concern that banks would be exposed to *PPSA* security interests which they would have no way of discovering.

As a result, the Minister of Finance introduced Senate Bill S-5, entitled the *Financial Systems Review Act,* in November 2011. In our newsletter dated March 2012, we provided an update on the status of Senate Bill S-5, the effect of which would be to amend the *Bank Act* and overturn the two Supreme Court of Canada decisions.

The *Financial Systems Review Act* received royal assent on March 29, 2012 and became law on May 24, 2012. It expressly provides that s. 427 security will have priority over the rights of "any person who had a security interest in that property that was unperfected at the time the bank acquired its security in the property." Subsection 425(1) was also amended by broadening the definition of the term "unperfected" to include a security interest that has not been registered under the law which the security interest was created.

The amendments also created an exception to a bank's priority if the bank has "knowledge" of the prior unperfected security interest. While the *PPSA* provides a definition of "knowledge", the *Bank Act* is silent on this

6 M.H. Ogilvie, *Canadian Banking Law*, 2nd ed. (Scarborough: Thomson Canada Limited, 1998) at 369 ["*Canadian Banking Law*"].
7 *Law of Banking, supra*, at 111.
8 *Royal Bank v. Nova Scotia (Workmen's Compensation Board)*, [1936] S.C.R. 560, 1936 CarswellNS 44 (S.C.C.).
9 *Ibid*. at para. 18.
10 *Personal Property Security Act,* R.S.O. 1990, c. P.10 ["*PPSA*"].
11 See *Bank of Montreal v. Innovation Credit Union*, 2010 SCC 47 at para. 9.
12 *Bank of Montreal v. Innovation Credit Union*, 2010 SCC 47 and *Royal Bank of Canada v. Radius Credit Union Ltd.*, 2010 SCC 28.

issue. As a result of this ambiguity, banks should tread cautiously when discussing finances with a debtor so as to avoid inadvertently obtaining what may be construed as "knowledge".

Priority between *Bank Act* Security and Landlord's Right of Distraint

When it comes to *Bank Act* security and a landlord's right of distraint, who has priority? The short answer is that the bank will have priority if its security is obtained *prior* to the tenant being in arrears of rent.

Two court decisions have provided guidance in this area. In *International Wood Products Ltd. v. Royal Bank*[13], the Ontario High Court confirmed that s. 89(1) [now s. 428] gives priority to the bank's security acquired pursuant to s. 427 over "all rights *subsequently* acquired in, on or in respect of" the property of a debtor.[14] The Court held that a landlord's right of distraint is a right "in, on or in respect of" the property, and as a result, if the arrears of rent (and thus the right of distraint) arises before the s. 427 security is taken, the bank's security under s. 427 will be subordinate to the landlord's rights.[15] Similarly, if the tenant is in arrears at the time the bank obtains s. 427 security and the tenant continues to default in payment of rent after the security is granted, the landlord will continue to have priority over the bank with respect to all of the rental arrears. This is because a landlord's right of distraint is only "lost" once the total amount of arrears is paid.[16]

In contrast, if security is obtained by the bank before the tenant enters into arrears, the bank's security will have priority. This is because the tenant no longer holds title to the assets. Accordingly, the landlord's right of distraint cannot attach to the tenant's assets once title has passed to the bank.[17] This was the finding by the Quebec Court of Appeal in *Fermo's Creations Inc. Re*[18].

Priority between two *Bank Act* Securities

Although *Bank Act* security is equivalent to the taking of title in the borrower's property, more than one bank can take security over the borrower's property, regardless of whether it is the same property or not.

The Saskatchewan Court of Appeal considered this issue and held that priority between two banks is determined based on the "first in time" rule.

In *Royal Bank v. Bank of Montreal*[19], a farmer - Mr. Dietz - borrowed money from the plaintiff and defendant banks and granted the banks s. 88 [now s. 427] security over his grain. The defendant, Bank of Montreal ("BMO"), had advanced three loans to the farmer – in August 1968, February 1969 and October 1969. The August 1968 loan was made for the express purpose of enabling Mr. Dietz to purchase a tractor.[20] Schedule "F" of the security document described the property that was assigned as security as follows:

> ... the undersigned hereby assigns to the Bank as security for the payment of the said loan ... the property hereinafter described of which the undersigned is now or may hereafter become the owner, to wit, ...
>
> <u>All of my threshed grain and without limiting the generality of the foregoing, the following</u>:
>
> 5000 bus wheat
>
> 1800 bus barley
>
> and which is now or may hereafter be in the place or places hereinafter designated, to wit, ...
>
> On or about my farmlands comprising ... (emphasis added)

The subsequent two loans advanced by BMO were also secured by Mr. Dietz's grain and the security documents were similarly worded as referenced above.

In July 1969, the plaintiff, Royal Bank of Canada ("RBC"), advanced a loan to Mr. Dietz and obtained s. 88 security over "all grain".[21]

The Court ultimately concluded that BMO's security had priority with respect to the August 1968 and February 1969 loans while RBC had priority with respect to the July 1969 loan (versus BMO's October 1969 loan).[22] In its reasoning, the Court noted that BMO's initial security document which referred to specific grain owned by Mr. Dietz did not limit the scope of the security since the overall wording of the document made it clear that security was assigned over all of the grain.[23]

Similarly, in another decision, the Court stated the following[24]:

> A first in time priority rule has also been applied

13 *International Wood Products Ltd. v. Royal Bank*, [1951] O.R. 642, 1951 CarswellOnt 71 (Ont. H.C.).

14 *Ibid*. at paras. 6-7.

15 *Ibid*. at para. 9.

16 George M. Valentini and Kristi Green, "Loss of Landlord's Right of Distress" in Harvey M. Haber, D*istress: A Commercial Landlord's Remedy* (Aurora: Canada Law Book Inc., 2001) at 81.

17 Also see Abraham Costin, "Priorities Between a Landlord's Right of Distress and Other Interests" in *Who Takes Priority? Evaluating Lending and Security Practices: Lessons from a Recession* (Toronto: Insight Press, 1993) at 7-8.

18 *Fermo's Creations Inc*. Re, (1969) 10 D.L.R. (3d) 560, 1969 CarswellQue 223 (Que. C.A.) at paras. 1-2 and 24-28.

19 *Royal Bank v. Bank of Montreal*, 1976 CarswellSask 55, [1976] 4 W.W.R. 721 (Sask. C.A.).

20 *Ibid*. at para. 2.

21 *Ibid*. at para. 8.

22 *Ibid*. at paras. 22, 25 and 28.

23 *Ibid*. at paras. 17 and 21.

24 *Innovation Credit Union v. Bank of Montreal*, 2009 SKCA 35, citing *Moose Jaw (City) v. Pulsar Ventures Inc*., [1988] 1 W.W.R. 250 (Sask. C.A.), at para. 22.

in a priority dispute between two banks each claiming section 178 [now s. 427] security interests in after-acquired property.

Conclusion

Although *Bank Act* security is not as common as it once was, it is important that banks understand and appreciate the requirements for this type of security interest. If applicable, *Bank Act* security has priority over an unperfected or unregistered security interest under the *PPSA*, provided that the bank has no knowledge of such security, and has priority over a landlord's right of distraint, if obtained prior to the borrower defaulting on rent.

Similarly, when it comes to competing security interests between two banks, the first bank to properly register its security will have priority. Banks will want to be proactive and avoid situations where their security could be subordinate to another bank's rights. While this could theoretically be avoided by taking security over some other inventory belonging to the borrower, banks must be cautious in using this approach. As evidenced in *Royal Bank v. Bank of Montreal*, above, courts have taken a liberal approach to interpreting the descriptions of the security in the documents giving security.[25] Though a bank may have the intention of securing a specific type of property, its security description may be interpreted broadly. Therefore, subsequent lenders should be cautious to avoid extending credit where the property provided for security may already be subject to a prior *Bank Act* security document.

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25 See *Canadian Banking Law, supra*, at 364.

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