Updates in Canadian Restructuring Case Law

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Introduction

The past year has brought us some interesting case law and legislative reform in the area of bankruptcy and insolvency and in secured lending. Insolvency reform appears to still be on track with Bill C-62 expected to be reviewed by the Senate in the fall. The amendments to the *Personal Property Security Act*[2] (Ontario) (the "Ontario PPSA") largely came into effect on August 1, 2007. As important developments, much has already been written and presented on these topics over the past few years.

The objective of this paper is more modest. Namely to provide an update on recent developments in the case law that will likely have some impact on how trustees, receivers and monitors practice and administer cases. These cases raise important questions about:

1. situations where a court ordered priming administrative charge over the assets of the debtor (securing fees and disbursements) may not be binding on a secured creditor;

2. traditional thinking and practice in respect of when it is too late for a secured creditor to perfect its security under the PPSA when the borrower is subject to insolvency or reorganization proceedings;

3. rights of unpaid suppliers to repossess commingled goods; and

4. other matters of interest, such as situations where a court might re-open a sale process in proceedings under the *Companies' Creditors Arrangement Act*[3] (the "CCAA"), guidance on whether a transaction is outside the ordinary course of business, whether certain licences are assignable by a trustee in bankruptcy, and how the New *Limitations Act, 2002*[4] (Ontario) has impacted the limitation period for demand note obligations.

Should a Receiver expect an Administrative Charge to prime Secured Creditors?

It has for some time been a well established practice for court appointed receivers to be granted a first ranking administrative charge over a debtor's property (i.e. priming existing secured creditors) to secure the receiver's fees and disbursements. However, in *Terra Nova Management Ltd. v. Halcyon Health Spa Ltd.*,[5] the British Columbia Court of Appeal held that a first ranking secured creditor, who had not received proper notice of, or consented to, the appointment of a receiver-manager, was not bound by a court order granting a prime ranking to

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[2] R.S.O. 1990, c. P.10.

[3] R.S.C. 1985, c. C-36, amended S.C. 1997.

[4] S.O. 2002, c. 24, Sch. B.

[5] (2006), 25 C.B.R. (5th) 199 (B.C. C.A.) [*Terra Nova*].

the receiver-manager's administrative charge. This decision serves as an important reminder that it should not be taken as a given that a receiver will automatically be granted a priming administrative charge in all cases and that certain best practices should be followed to mitigate the risk that a receiver will face the prospect of having no source of recovery for its fees and disbursements.

Terra Nova Management Ltd. v. Halcyon Health Spa Ltd.

Halcyon Health Spa Ltd. ("Halcyon") operated a spa resort in British Columbia. Halcyon granted first ranking security to the Business Development Bank of Canada ("BDC") and second ranking security to Terra Nova Management Ltd. ("Terra Nova"). Halcyon fell into financial difficulties and Terra Nova brought an application to have Arthur Andersen Inc. ("Andersen") appointed as receiver-manager of Halcyon. Importantly, Terra Nova did not serve BDC or give BDC prior notice of its intention to seek the appointment of a receiver. It appears that BDC felt that there was significant equity in the assets of Halcyon and that it was not necessary to seek the appointment of a receiver itself. After the appointment of Andersen as receiver-manager, BDC's solicitor received a copy of the receivership order, but BDC did not move to set aside or vary the order.

The terms of the administrative order provided that Andersen's fees and expenditures would create a charge on Halcyon's assets in priority to non-statutory charges. Possibly relying on the value of Halcyon's property and the first ranking administrative charge, Andersen did not obtain an indemnity for its fees and disbursements from Terra Nova.

It was only after a failed sale process and at a motion to determine Andersen's entitlement to a forfeited deposit to cover its fees and expenses that BDC challenged the priority of the receiver's administrative charge. Andersen had not disclosed in its court reports that it intended to use the forfeited deposit to pay its fees and disbursements.

The British Columbia Superior Court of Justice reviewed the leading Ontario Court of Appeal decision in *Kowal Investments et al. v. Deeder Electric Ltd.*,[6] which set out three exceptions to the general rule that a receiver has no priority for his expenses over a prior secured creditor:

> 1. If the receiver was appointed at the request, or with the consent or approval, of the security holders, the receiver will be given priority over the security holders;[7]
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> 2. If the receiver was appointed to preserve and realize assets for the benefit of all interested parties, including secured creditors, the receiver will be given priority over

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[6] (1976), 9 O.R. (2d) 84 (C.A.).

[7] *Ibid*. at 496.

> the secured creditors for charges and expenses properly incurred by him;[8] and
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> 3. If the receiver expended money for the necessary preservation or improvement of the property, he may be given priority for such expenditure over secured creditors.[9]

The Superior Court held that the threshold consideration, before considering the above three exceptions, is whether a receivership was necessary in the circumstances to protect or realize the interests of the secured creditors. Thus, the above three exceptions would only apply if the receivership was in fact necessary.

Based on the particular facts of the case, the Superior Court decided that the appointment of Andersen was not necessary to protect BDC's interests as there was sufficient equity in the property securing BDC's mortgage debt when Andersen was appointed as receiver-manager.[10] Nevertheless, the Court went on to consider whether any exception would entitle Andersen to priority over BDC for its fees and expenses.

Despite the fact that BDC had knowledge of the administrative order, the Court held that the BDC had not consented to or acquiesced in Andersen's appointment as receiver-manager.[11] The Court also held that Anderson's appointment was not for the benefit of all interested parties and, in particular, not for BDC's benefit.

Based on the Superior Court's reasoning, the British Columbia Court of Appeal held that BDC had not received proper notice of, or consented to, the proceedings and, thus, was not under a positive duty to preserve its priority by disputing the terms of the administrative order. The Court of Appeal concluded that, due to the specific facts of the case, BDC was entitled to wait until realization of the debtor's assets to address the difficulty created by the administrative charge. The receiver-manager was not entitled to priority for its fees and expenses over the security held by BDC and, through its conduct, the receiver-manager had assumed the risk of any shortfall.[12] Accordingly, the Court of Appeal dismissed the appeal.

Practice Points

The decision in *Terra Nova* reinforces that receivers should serve notice on principal secured creditors whose security interests the receiver seeks to have primed by a court ordered administrative charge. Receivers should also disclose in court reports any intention to apply proceeds or realizations as against their fees and disbursements. Finally, receivers should

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[8] *Ibid*. at 497.

[9] *Ibid*. at 499.

[10] *Terra Nova*, *supra* note 5 at para. 9.

[11] *Ibid*. at para. 11.

[12] *Ibid*. at para. 14.

consider obtaining a fee and disbursement guarantee from the appointing creditor if the appointing creditor refuses to provide a full indemnification.

Perfected Against a Receiver but not a Subsequently Appointed Trustee?

Re 1231640 Ontario Inc.[13] (formerly known as the State Group Limited)

Is a receiver a representative of creditors for the purposes of s. 20(1)(b) of the Ontario PPSA? Should a secured creditor, whose security interest was perfected at the time the court appointed a receiver, be treated as an unsecured creditor if its security interest becomes unperfected prior to the appointment of a trustee in bankruptcy?

Section 20(1)(b) of the Ontario PPSA provides that an unperfected security interest, although effective against the debtor, is not effective against a person who represents the creditors of the debtor, including an assignee for the benefit of creditors and a trustee in bankruptcy. Under s. 20(2)(b), the rights of a person who represents the creditors of the debtor with respect to collateral are determined as of the date on which the person's representative status takes effect.

In *State Group*, the Ontario Superior Court of Justice decided that an interim receiver appointed under s. 47(1) of the *Bankruptcy and Insolvency Act*[14] (the "BIA") is not "a person who represents creditors" under s. 20(1) of the Ontario PPSA. However, once the interim receiver was also appointed trustee in bankruptcy of the debtor's estate, it became a representative of the creditors of the debtor for the purposes of s. 20(1) of the Ontario PPSA. Accordingly, a security interest that was perfected prior to the appointment of the interim receiver but unperfected at the time of the trustee's appointment was held to be ineffective as against the trustee.

The case involved an application by PricewaterhouseCoopers Inc. ("PWC"), in its capacity as Trustee in bankruptcy for advice and direction as to whether security granted by State to Royal Bank of Canada as agent for certain lenders (the "Agent") was effective as against the Trustee. PWC had initially been appointed on the application of the Agent as interim receiver of State under s. 47(1) of the BIA. The appointment order provided for a stay of proceedings and PWC was authorized to carry on State's business, sell certain assets and eventually assign State into bankruptcy. Under the terms of an asset purchase agreement entered into by the interim receiver, State was required to change its name. Accordingly, the interim receiver filed articles of amendment to change State's name to 1231640 Ontario Inc. Unfortunately, the Agent did not file a financing change statement to reflect this name change as required pursuant to s. 48(3) of the Ontario PPSA. Pursuant to the terms of the receivership order, the interim receiver then made an assignment in bankruptcy on behalf of State and PWC was appointed as Trustee.

The critical issue before the Court was whether PWC became "a person who represents the creditors" on the date of its appointment as an interim receiver or on the date of its

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[13] (2006), 23 C.B.R. (5th) 92 (Ont. S.C.J.) [*State Group*].

[14] R.S.C. 1985, c. B-3.

appointment as Trustee. If PWC became a representative of the creditors when it was appointed as interim receiver, the secured creditors' respective priorities would have crystallized before the name change and the Agent's security interest would remain effective as against the Trustee, regardless of the Agent's failure to register a financing change statement. However, if PWC did not become a representative of the creditors until its appointment as Trustee, the Agent's security interest would be unperfected and ineffective against the Trustee due its failure to amend its registration within 30 days after learning of the name change.

The Court decided that an interim receiver appointed under s. 47(1) of the BIA was not "a person who represents the creditors of the debtor" under s. 20(1)(b) of the Ontario PPSA. To determine the status of the interim receiver, the Court contrasted the rights and duties of the interim receiver to those of a trustee in bankruptcy. The Court held that the interim receiver was appointed by the Agent to enforce its security interest and did not acquire title to the debtor's property or the authority to settle or compromise liabilities owed to other creditors.[15] As a result, PWC did not become "a person who represents the creditors" until its appointment as Trustee, at which time the Agent's security interest was unperfected and, thus, unenforceable against the Trustee.

The Agent argued that there were overriding business and policy reasons why a secured creditor should not lose its priority by complying with the stay provisions of an Appointment Order that restrained further registrations. However, the Court refused to exercise its inherent jurisdiction to override s. 48(3) of the Ontario PPSA, which provides for the filing of a Financing Change Statement within 30 days after the creditor becomes aware of the debtor's change of name. Further, the judge noted that bankruptcy courts clearly have authority to issue orders lifting any stay to permit such filing.[16] As a result, there was no "legislative gap" in the Ontario PPSA that should be filled through inherent jurisdiction.[17] The Court held that the stay of proceedings did not preclude the Agent from registering a financing change statement. The Agent could have maintained its security by bringing a motion to lift the stay of proceedings to allow it to file a financing change statement in order to maintain the perfected status of its security interest.[18]

In conclusion, the Court held that PWC was not a representative of the creditors until it was appointed as Trustee and, since the Agent's security interest was unperfected at the time of the bankruptcy, it was ineffective as against PWC as Trustee.

The Agent appealed the decision to the Ontario Court of Appeal. The appeal was heard in May of 2007 and the decision of the Court of Appeal remains pending.

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[15] *Ibid*. at para. 35.

[16] *Ibid*. at para. 51.

[17] *Ibid*. at para. 51.

[18] *Ibid*. at para. 43.

Practice Points

The Ontario Superior Court of Justice's decision in *State Group* raises interesting practical consequences for secured creditors and court officers in insolvency proceedings. Secured creditors in Ontario will need to be vigilant in ensuring that their security interests under the Ontario PPSA are perfected throughout receivership proceedings to avoid losing secured status if a trustee in bankruptcy is subsequently appointed and further distributions are expected. The ability of secured creditors to maintain their perfection under the Ontario PPSA will likely become a more mechanical exercise in future as parties begin to adopt the Model Receivership Order which carves out registration of security interests from the scope of the stay of proceedings.

However, what happens if a distribution is made to secured creditors without notice to all creditors before a secured creditor prefects its security interest? In addition, a trustee in bankruptcy will now have a duty to verify that security interests perfected at the commencement of a receivership continue to be perfected on the date of bankruptcy. Finally, if a receiver is not a representative of creditors for the purposes of s. 20(1)(b), will the claim of an unperfected secured creditor rank ahead of unsecured creditors in a receivership?

Brookside Capital Partners Inc. v. Kodiak Energy Services Ltd. (Receiver-Manager of)[19]

Section 20(a)(i) of the Alberta *Personal Property Security Act*[20] (the "Alberta PPSA") provides that a security interest in collateral is not effective against a trustee in bankruptcy if the security interest is unperfected at the date of the bankruptcy. This section is much more narrowly drafted than the parallel provision under s. 20(1)(b) of the Ontario PPSA, as considered in *State*, which provides that an unperfected security interest, although effective against the debtor, is not effective against a person who represents the creditors of the debtor, including an assignee for the benefit of creditors and a trustee in bankruptcy.

In *Brookside*, the Alberta Court of Queen's Bench held that the statutory power of a "trustee in bankruptcy" under s. 20(a)(i) of the Alberta PPSA does not extend to include a receiver appointed pursuant to s. 13 of the *Judicature Act*[21] (the "JA"). This permitted a creditor to perfect its security interest under the Alberta PPSA after the appointment of the receiver.

The debtor, Kodiak Energy Services Ltd., was involved in CCAA proceedings, which culminated in the appointment of a receiver-manager under s. 13 of the JA to sell the debtor's assets and distribute the proceeds. The applicant, Brookside, held a $450,000 fixed and floating charge debenture secured by all of the "present and after acquired real and personal property and assets…" of the debtor.[22] Unfortunately for Brookside, at the time the receivership order was granted, Brookside's security interest was unperfected due to an error in the

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[19] (2006), 25 C.B.R. (5th) 273 (Alta. Q.B.) [*Brookside*].

[20] R.S.A. 2000, c. P-7.

[21] R.S.A. 2000, c. J-2.

[22] *Brookside*, *supra* note 19 at para. 10.

registration of its financing statement. Brookside sought to lift the stay of proceedings to validate the financing change statement it had filed to correct the error.

The application gave rise to two issues: (1) whether a receiver was entitled to the same priority as is granted to a trustee in bankruptcy under s. 20(a)(i) of the Alberta PPSA; and (2) whether the stays of proceedings under the initial order and the receivership order should be lifted for the limited purpose of validating Brookside's financing change statement.

Considering the first issue, the Court held that the words "trustee" and "receiver" were not juristically interchangeable. The Court stated that the BIA and the JA "are different statutes from different levels of government with largely different purposes".[23] Accordingly, a receiver under the JA was not entitled to the same priority as a trustee in bankruptcy under s. 20(a)(i) of the Alberta PPSA. To hold otherwise could only be supported by an amendment to the provision.[24]

Turning to the second issue, the Court held that it was just and equitable in the circumstances to lift the stay and validate Brookside's financing change statement. The debenture held by Brookside was intended to be a secured instrument. Brookside was not attempting to gain an advantage, but was rather trying to hold onto an advantage it had already negotiated with the debtor.[25] Further, other creditors had not enforced their security interests based on the Personal Property Registry's lack of disclosure of Brookside's security interest.[26] Finally, since the initial order and receivership order were made at the instance of the debtor, the debtor and other creditors would not suffer prejudice as a result of Brookside's amended registration.[27] If the debtor had not obtained the CCAA and receivership stays, Brookside would have been entitled to register its financing change statement at any time and perfect its security interest. On balance, the greater prejudice would be to Brookside if it was not allowed to amend its security registration.[28]

Practice Points

Section 20(a)(i) of the Alberta PPSA contains narrower language than s. 20(1)(b) of the Ontario PPSA. Therefore, if the Ontario Court of Appeal reverses the lower court decision in the *State Group* case, national receivers may be faced with the odd situation where a creditor could perfect a security interest in Alberta after the appointment of the receiver, but could not do so in Ontario.

The Court in *Brookside* seems to have left open the possibility that leave to lift the stay to re-perfect or perfect a security interest may not be granted if the creditor is trying to

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[23] *Ibid*. at para. 28.

[24] *Ibid*. at para. 29.

[25] *Ibid*. at para. 36.

[26] *Ibid*. at para. 37.

[27] *Ibid*. at para. 38.

[28] *Ibid*. at para. 44.

obtain an unfair advantage or if doing so would have an adverse effect on the reorganization of the debtor.

Pioneer Grain Co. v. Sullivan & Associates Inc.[29]

Pioneer is another decision that considered the question of when it is too late to perfect a security interest under the Saskatchewan *Personal Property Security Act*[30] (the "Saskatchewan PPSA") albeit in the context of a proposal under the BIA. An application was made by a creditor, which had a valid undisputed security agreement but that was unperfected, to appeal the trustee's decision to disallow its claim as a secured creditor in the proposal under s. 135(4) of the BIA. The creditor was admitted as an unsecured creditor because it had not registered under the Saskatchewan PPSA prior to the date of the debtor's proposal. The creditor sought leave to register a financing statement.

In this case the Registrar of the Saskatchewan Queen's Bench emphasized the importance of certainty and the use of definitive dates to classify creditors' claims in the proposal process. The Court dismissed the appeal on the basis that s. 62.(1.1) of the BIA provided a definitive date to determine the claims of secured creditors in the proposal. The Court held that the trustee's determination of claims and the development of the bankruptcy proposal was based upon the trustee's various registry searches relevant to a fixed date. The Court stated that "[i]t would be virtually impossible for a trustee to make recommendations and for creditors to make reasoned decisions if the ranking of creditors' claims could change post filing date."[31] The Court also held that the applicant's ability to register its security agreement after the date the proposal was filed was contrary to the statutory stay provision in s. 69(1)(a) of the BIA.[32] The Court also commented that s. 20(2)(a) of the Saskatchewan PPSA, which provides that a security interest in collateral is not effective against a trustee in bankruptcy if the security interest is unperfected at the date of bankruptcy, was not applicable to proposals under the BIA. Only an amendment to the Saskatchewan PPSA could extend the application of "trustee in bankruptcy" under s. 20(2)(a) of the Saskatchewan PPSA to a trustee in proposals under the BIA.[33]

In June of this year the Saskatchewan Court of Appeal overturned the decision of the Registrar and ruled in favour of the creditor's petition to register its financing statement.[34] The Court of Appeal provided a purposive interpretation of both the BIA and of the Saskatchewan PPSA to support its position. It held that the BIA is not the determinate statute on this specific point but it rather that the Saskatchewan PPSA governed the point. It held that there was no actual or deemed bankruptcy at the time the creditor filed its financing statement. The Court of Appeal stated that unless the language of the Act specifically provides for a scenario

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[29] (2006), 24 C.B.R. (5th) 247 (Sask. Q.B.) [*Pioneer*].

[30] S.S. 1993, c. P-6.2.

[31] *Pioneer*, *supra* note 29 at para. 19.

[32] *Ibid*. at para. 20.

[33] *Ibid*. at para. 22.

[34] [2007] SKCA 73.

under which the secured interest of a creditor, perfected or not, is defeated by unsecured creditors then a secured creditor, even unperfected, maintains precedence.[35] With regard to the lower court's stance towards s. 69(1)(a) of the BIA, the Court of Appeal ruled that an historical interpretation of s. 57 of the BIA makes clear that the earliest date upon which an act of bankruptcy is committed, by virtue of the proposal process, is when the proposal is refused.[36] In this case, the creditor had registered and perfected its security interest prior to any decision regarding the proposal and was as a result in full compliance with the requirements of both the Saskatchewan PPSA and the BIA.

In terms of s. 20(2)(a) of the Saskatchewan PPSA, the Court of Appeal stood in agreement with the lower court's interpretation of the section and in its assertion that only an amendment to the PPSA could expand the scope of the section beyond trustees in bankruptcy to also include trustees in proposals.[37]

Practice Points

This decision raises real and practical problems for debtors, the debtor's advisors and turnaround specialists in formulating viable proposals on a timely basis. A simple review of a PPSA search certificate on or before the time of filing a proposal will not be sufficient to determine the debtor's potential secured creditors under the PPSA. Officers and directors of debtor companies will need to consider what their duties may be if they are aware of material claims that are unperfected under the Saskatchewan PPSA at the time the proposal is filed. Other creditors will need to consider how they can prevent an unperfected secured creditor from getting a leg-up over them as compared to the situation if there was a bankruptcy at the time in question. Turnaround specialists and advisors to the debtor may need to consider whether a court-ordered bar date could be established for the perfection of unperfected security interests (perhaps as part of a claims process) to establish some finality for the date for which unperfected secured claims can be validly perfected. A host of real practical concerns recognized by the Registrar in the *Pioneer* case need to be addressed and dealt with in future cases.

Re TRG Services Inc.[38]

In *TRG Services*, the Ontario Superior Court of Justice considered whether an alleged security interest that was unperfected on the date of the debtor's filing under the CCAA could be asserted, if perfected, as a secured claim in a plan of arrangement that contemplated a liquidation. Cisco Systems Canada Co. ("Cisco") had supplied networking equipment and related technologies to RAM Inc. (the "Debtor") pursuant to an agreement of purchase and sale. The Debtor subsequently entered into CCAA proceedings and an initial plan of arrangement (the "Plan") was proposed for approval by the creditors. The Plan provided that secured creditors who had perfected their security by a fixed date would be unaffected by the Plan. As a result,

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[35] *Ibid.* at para. 17.

[36] *Ibid.* at para. 24.

[37] *Ibid.* at para 19 & 27.

[38] (2006), 26 C.B.R. (5th) 203 (Ont. S.C.J.) [*TRG Services*].

creditors who had not perfected their security interests by the fixed date would be grouped into a single class of unsecured creditors.

Cisco filed a proof of claim as a secured creditor on the basis that the payment clause maintained in the purchase and sale agreement had granted Cisco a security interest in the supplies purchased by the Debtor. However, the Monitor disallowed the claim on the basis that Cisco did not register a financing statement under the PPSA prior to the fixed date in the Plan and admitted Cisco as an unsecured creditor. In response, Cisco brought two motions: (1) to appeal from the disallowance of its secured claim by the Monitor; and (2) to lift the CCAA stay of proceedings to allow it to register its alleged security interest under the Ontario PPSA.

The Monitor disputed both motions. There were several reasons why it had disallowed Cisco's claim for secured creditor status. First, it was not clear in the purchase and sale agreement whether the Debtor had actually intended to provide Cisco with security and whether Cisco believed it had a registrable security interest. Second, Cisco had failed to register its alleged security interest prior to the fixed date contemplated in the Plan. Third, the unperfected security interest, if it existed, was ineffective as against the Monitor because the Monitor was a "person who represents the creditors of the debtor" under s. 20(1)(b) of the Ontario PPSA.

The Ontario Superior Court of Justice was not satisfied that the Monitor was a representative of the Debtor's creditors within the meaning of s. 20(1)(b) of the Ontario PPSA. Although the Monitor had the power to determine the claims of individual creditors, it had not been granted any legal entitlement to or over the assets of the debtor for the benefit of all creditors.[39] As a result, Cisco's alleged security interest was not ineffective as against the Monitor for the purposes of the motions.

The Debtor disputed the motions, arguing that when the Plan was created, it did not know that Cisco would claim status as a secured creditor. The Debtor submitted that Cisco had deliberately not perfected its security prior to the formulation of the Plan and that granting Cisco status as a secured creditor would create enormous uncertainty and inequities in the CCAA process, including:

> (a) The debtor and its counsel, the monitor and other parties involved in the CCAA process would not be able to rely upon land title or personal property registry searches to determine the nature and quantum of potential secured claims against the debtor's assets;
>
> (b) This would make it difficult for the parties and their counsel to assess the appropriateness of proceedings under the CCAA as opposed to receivership proceedings, proceedings under the BIA or other proceedings;

[39] *TRG Services*, *supra* note 34 at para. 57.

> (c) Any creditors whose contracts contained title reservation clauses or security provisions could claim as secured creditors under the CCAA and obtain preferential treatment over other creditors, without having taken the steps necessary to give them such priority;
>
> (d) Creditors who would all be treated the same way in receivership, proposal, bankruptcy or other similar proceedings would not be treated the same way under the CCAA;
>
> (e) There would be potential wasted costs, where unregistered secured creditors come forward late in the process, necessitating conversion to other proceedings to ensure fairness and protect the interests of all creditors.[40]

The Debtor also distinguished the facts of the case from the Alberta Court of Queen's Bench decision in *Brookside*,[41] where the Court granted leave to lift a CCAA stay of proceedings to allow a creditor to re-perfect its security interest. As noted above, the Court in *Brookside* based its decision to grant leave on the following factors:

> 1) The debenture was a security instrument and the debtor company had clearly intended to grant a security interest to the creditor;
>
> 2) The creditor had not attempted to gain an advantage through delayed registration, but rather tried to hold onto an advantage it had already negotiated with the debtor company.
>
> 3) Other creditors had not relied on the Personal Property Registry's lack of disclosure of the security interest before enforcing their security interests.
>
> 4) There would be no prejudice to the debtor company or other creditors if the security interest was re-perfected.[42]

The Debtor argued that the above factors did not apply to the situation in *TRG Services*. It was not clear whether Cisco received a security interest through the agreement of purchase and sale. In *Brookside*, the secured party unintentionally failed to correct an existing registration. The Debtor argued that Cisco had deliberately failed to register until six months after the CCAA filing and after the Plan had been proposed. Thus, if Cisco's claim was granted

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[40] *Ibid*. at para. 36.

[41] *Brookside*, *supra* note 19.

[42] *TRG Services*, *supra* note 34 at para. 52.

secured creditor status, the positions of the Debtor and other creditors involved in formulating the liquidation Plan would be seriously prejudiced.[43]

Notwithstanding the Debtor's arguments and the likelihood that an assignment in bankruptcy would result, the Superior Court of Justice held that there was nothing in the CCAA to permit the Court to displace the security of a creditor simply because the security is unperfected.[44] It acknowledged that the breadth and flexibility of the CCAA should not be extended to defeat a creditor that has security.[45] Consequently, Cisco was entitled to perfect its security by registration under the Ontario PPSA. However, as a condition of lifting the stay, Cisco would bear the reasonable expenses and costs of the Debtor and unsecured creditors associated with the delay in perfection of its security.[46]

Practice Points

TRG Services gives rise to significant issues for restructuring practitioners and the restructuring process in general. There is now greater uncertainty in designing and implementing a plan of arrangement under the CCAA. It now appears that it will be difficult to determine with certainty whether a creditor will be treated as a secured creditor under a plan simply by ordering an Ontario PPSA security certificate. Plans structured on certain understandings about which creditors are secured or unsecured will be subject to change as these initial understandings will now be treated as fluid. In other words, what might be a correct statement of the relative priorities of creditors today, may be wrong tomorrow. This could undermine the assumptions behind a plan of arrangement. An alternative may be to choose a BIA proposal over a CCAA filing to provide greater certainty in the restructuring process. However, this is just one factor of many that should be considered before a filing regime is selected.

Are commingled goods "identifiable" under s. 81.1 of the BIA?

Port Alice Specialty Cellulose Inc. Re,[47]

In *Port Alice Specialty Cellulose Inc.*, the British Columbia Court of Appeal considered whether commingled goods were "identifiable" under s. 81.1 of the BIA. A supplier had delivered 23,598 barrels of fuel oil (the "New Oil") to a mill for which it had not been fully paid. The fuel was placed in a storage tank that already contained 18,801 barrels of fuel oil (the "Old Oil") from a previous delivery by the same supplier. The mill became bankrupt and there were only 24,417 barrels of fuel oil remaining in the tank. Consequently, the supplier demanded repossession of the fuel as an "unpaid supplier" under s. 81.1 of the BIA. The trustee in bankruptcy sought advice and direction from the court as to whether the supplier could satisfy

[43] *Ibid*. at para. 53.

[44] *Ibid*. at para. 59.

[45] *Ibid*. at para. 69.

[46] *Ibid*. at para. 76.

[47] (2005), 11 C.B.R. (5th) 279 (B.C. C.A.).

the requirement in s. 81.1(c)(ii) of the BIA that the New Oil was "identifiable as the goods delivered by the supplier and not fully paid for".

The motions judge held that the supplier could repossess the same proportion of the fuel oil remaining in the tank as the New Oil was to the Old Oil when the New Oil was first delivered on the theory that notwithstanding that the goods were co-mingled, the shipments were still identifiable. That amount was calculated to be 56 per cent.[48] The Court based its decision on the following facts:

> (a) The New Oil was delivered to a single tank and was stored there;
>
> (b) All of the previous four deliveries were made by the supplier and no deliveries of any further fuel subsequent to the New Oil had been made;
>
> (c) The qualities of the New and Old Oil were the same and the fuel in the tank remained the same;
>
> (d) The volume of the fuel in the tank before delivery of the New Oil into the tank was known and ascertained;
>
> (e) The volume of the New Oil pumped into the tank was known and ascertained;
>
> (f) The volume of fuel oil drawn down was known and ascertained; and
>
> (g) The fuel in the tank could be inferred to have been evenly drawn down.[49]

The British Columbia Court of Appeal agreed with the Superior Court decision. It held that the lower court's inference that the New Oil and Old Oil were evenly drawn down was reasonable and based on the undisputed fact that the New Oil was commingled with the Old Oil and could not be physically separated or measured.[50] The lower court had correctly concluded that the BIA should not be given an overly narrow interpretation as it is a commercial statute used by business people. As well, s. 81.1 should not be read to exclude fungible goods such as fuel oil.[51] As a result, the Court of Appeal dismissed the Trustee's appeal and the cross-appeal.

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[48] *Ibid*. at para. 13.

[49] *Ibid*. at para. 12.

[50] *Ibid*. at para. 19.

[51] *Ibid*. at para. 27-29, 40.

Practice Points

If read narrowly, the decision in *Port Alice Specialty Cellulose Inc.* may have the effect of improving the ability of suppliers to recover fungible goods shipped within the statutory repossession period that are commingled with prior shipments by the same supplier outside of the repossession period. It remains to be seen how far courts may be prepared to extend the principle in this decision that fungible goods are "identifiable" when commingled.

When will the court re-open the sale of property subject to CCAA proceedings?

1587930 Ontario Ltd., Re[52]

In *1587930 Ontario Ltd.*, the Ontario Superior Court of Justice re-opened the sale of a hotel property for a very short timeframe (30 days) to consider further offers for a debtor company's assets under the CCAA because there was "at least the potential for a much-improved return for unsecured creditors".[53] The Monitor had recommended a plan of arrangement for approval by the court, which contained an offer to purchase the hotel property. At that motion it was identified to the court that there was an offer to purchase the hotel property for an amount in excess of the earlier offer. The higher offer was conditional at first. However, the offeror confirmed the offer and another motion was commenced to determine how the offer should be considered in the sale process since it was made after the end of the offer period.

The Court held that while the possibility of an increased return for unsecured creditors was not the only consideration to re-open the sale, it was a significant factor. Furthermore, the unsecured creditors were willing to bear the risk that the debtor's estate was depreciating in excess of $500,000 per month.[54]

In doing so, the Court re-opened the sale process to permit a last-minute topping bid to be considered with other bids. The Court decided not to order outright acceptance of the topping bid because of the inequity it would cause to the earlier bidder. Thus, the Court re-opened the sale process for a limited time to allow for consideration of additional offers.

Practice Points

The decision in *1587930 Ontario Ltd.* provides an example of when a sale process may be reopened. It's the author's view that the decision departs from leading Ontario authorities that support the position that the court should not consider offers from prospective purchasers at the "eleventh hour" because to do so would undermine the integrity and fairness of the sale process.[55] It is also unfair to those bidders that comply with the terms of the sale process. As a

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[52] (2006), 25 C.B.R. (5th) 260 (Ont. S.C.J.).

[53] *Ibid*. at para. 19.

[54] *Ibid*. at para. 20.

[55] For further discussion on such case law see: Waël Rostom and Andrew J.F. Kent, "Legal Strategies for Acquiring Distressed Business in Canada" in *Corporate Finance for Canadian Executives* (Toronto: Thomson Carswell, 2007) 423 at 436 to 439.

result of the decision in *1587930 Ontario Ltd.*, there is a risk that some prospective purchasers may be emboldened to "game" the sale process by making last minute topping bids.

<u>When is a transaction outside the ordinary course of business?</u>

Re Stelco Inc.[56]

In *Stelco*, the Ontario Court of Appeal considered four appeals arising from the proceedings involving Stelco Inc. under the CCAA. The third appeal concerned a dispute over the characterization of debt to determine whether Stelco Inc.'s indebtedness to EDS placed 2074600 Ontario Inc., the assignee of EDS's claim against Stelco Inc., in the creditor class of Senior Debtor Holders and therefore entitled 2074600 Ontario Inc. to its *pro rata* share of the Turnover Proceeds. The central issue was whether Stelco Inc.'s indebtedness to EDS fell within the definition of "Senior Debt" in the Note Indenture, which excluded indebtedness incurred in relation to any acquisition made in the *ordinary course of business*. (Emphasis added).

The motion judge had concluded that the EDS claim, based on a large technology outsourcing agreement, did not constitute "Senior Debt" because the debt was incurred through an acquisition in the ordinary course of business. While the motion judge took a broad approach to transactions in the ordinary course of business, he interpreted transactions outside the ordinary course of business very narrowly. For a transaction to qualify as outside the ordinary course a business, the motion judge held that the transaction must have the effect of "*significantly changing* either (a) the nature of the business conducted by Stelco (the goods and services it produced or sold, the scale of its operations, the manner of manufacturing or distributing the products it sold); and/or (b) the financial results of Stelco".[57]

The Ontario Court of Appeal disagreed. It held that the motion judge had set an "unsuitably high standard"[58] for transactions outside the ordinary course of business and concluded that the property, services and assets provided in relation to the EDS claim were not acquisitions made in the ordinary course of business and, thus, the EDS claim constituted "Senior Debt" within the meaning of the Note Indenture. In reaching this conclusion, the Court held that "ordinary course of business" is a legal notion and a question of "mixed fact and law" that must be determined in light of the circumstances of each case.[59] The Court set out the following "helpful benchmarks" from a review of the authorities to determine whether a transaction falls within the ordinary course of business:

> (a) the transaction is distinguishable from the normal course of the company's operations because of its particular complexity or its far-reaching or otherwise unusual nature;

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[56] (2007), ONCA 483.

[57] *Ibid*. at para. 95.

[58] *Ibid*. at para. 102.

[59] *Ibid*. at para. 81.

> (b) the transaction arose out of some special or peculiar situation;
>
> (c) the transaction required approval from the company's shareholders or board of directors;
>
> (d) the transaction was given special notice by the company;
>
> (e) the transaction was an unusual or isolated undertaking as opposed to a routine one; or
>
> (f) the transaction is reflective of standard practice in the relative industry.[60]

Applying these factors to the EDS claim, the Court concluded that the acquisition was indeed outside the ordinary course of business. First, the acquisition was a "uniquely comprehensive and significant" contract for Information Technology ("IT") services involving more than $320 million payable by Stelco Inc. over its ten-year term.[61] The effect of the acquisition was to "overhaul and change completely Stelco's manufacturing, asset management, human resources and financial management systems".[62] Second, it was a "one-time transaction – isolated, unusual, and far from routine in the course of Stelco's business".[63] Third, the transaction received special notice. Stelco publicly announced the transaction, a step that Stelco rarely took when entering into service contracts, and specifically mentioned it on its financial statements.[64] Fourth, the transaction involved complex financing provisions that were unusual to Stelco and EDS.[65] Finally, the transaction had required and received approval from Stelco's board of directors.[66]

Although others in the steel industry were also outsourcing their IT and Stelco had outsourced other services in the past, the Court held these factors were not indicative of an acquisition in the ordinary course of business. Such factors simply established that the outsourcing particular business practice was increasing in popularity.[67]

The Court concluded that the acquisitions for the property, services and assets provided with respect to the EDS claim were not acquisitions made in the ordinary course of business.

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[60] *Ibid*. at para. 101.

[61] *Ibid*. at para. 104.

[62] *Ibid*. at para. 105.

[63] *Ibid*. at para. 107.

[64] *Ibid*. at para. 108.

[65] *Ibid*. at para. 109.

[66] *Ibid*. at para. 110.

[67] *Ibid*. at para. 111.

The appeal was allowed and 2074600 Ontario Inc. was entitled to its *pro rata* share of the Turnover Proceeds as a Senior Debt Holder.[68]

Practice Points

Stelco may provide a useful reference for insolvency professionals in determining whether a transaction is outside the ordinary course of business.

Is a fishing licence property for the purposes of the PPSA and BIA?

Saulnier (Receiver of) v. Saulnier[69]

In *Saulnier*, the Nova Scotia Court of Appeal held that the holder's rights respecting four fishing licences with a combined value in excess of $600,000 were intangible property that could pass to the trustee in bankruptcy under the BIA and to secured creditors under the Nova Scotia *Personal Property Security Act*[70] (the "Nova Scotia PPSA"). The Court rejected the commercial reality approach taken by the lower court and departed from leading Ontario authorities which characterize personal property in licences and quotas based largely on the amount of control involved in the granting and reissuing process.[71] In February 2007, leave was granted by the Supreme Court of Canada to appeal *Saulnier*. This provides a unique opportunity for the Supreme Court of Canada to address and resolve the conflicting case law interpreting the proprietary nature of licences and quotas in Canada.

Mr. Saulnier, a fisherman, held four fishing licences. To finance his fishing operations, Mr. Saulnier granted a security interest over all his present and after acquired property, including "intangibles" to the Royal Bank of Canada (the "Bank"). However, when Mr. Saulnier defaulted on his obligations under the loan and made an assignment in bankruptcy, the Bank applied to the court for an order that Mr. Saulnier's fishing licences were "intangibles" for the purposes of the BIA and the Nova Scotia PPSA. As such, the Bank could sell the licences and obtain priority in the proceeds over the Trustee in bankruptcy.

The Nova Scotia Superior Court of Justice granted the Bank's motion. Applying a commercial reality approach, the Court held that although the licences did not give exclusive control to Mr. Saulnier, they provided Mr. Saulnier with a bundle of rights that constituted marketable property capable of providing security. Consequently, the Court ordered that the licences were property which could be charged under a security agreement made pursuant to the Nova Scotia PPSA and were property that could pass to the Trustee in bankruptcy pursuant to the BIA.[72]

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[68] *Ibid*. at para. 113.

[69] (2006), NSCA 91 (N.S. C.A.) [*Saulnier*].

[70] S.N.S. 1995-95, c. 13.

[71] See the leading Ontario Court of Appeal decision in *National Trust Co. v. Bouckhuyt* (1987), 23 O.A.C. 40 and cases following that decision.

[72] *Saulnier*, *supra* note 65 at para. 10.

The Nova Scotia Court of Appeal rejected the commercial reality approach. It held that the appropriate consideration was not the market value of the licences, but rather whether the licences where "property" as defined under the BIA and Nova Scotia PPSA.[73] The Court explained that that property was a bundle of rights that could be divided between people. It held that while Mr. Saulnier did not hold property in the licences themselves because they were the property of the Crown, there were two intangible rights in relation to the licences that met the definitions of property under the BIA and the Nova Scotia PPSA. First, Mr. Saulnier held a beneficial interest in the earnings from the licence. Second, Mr. Saulnier held limited rights to apply for the renewal or reissuance of the licences and to resist an arbitrary denial of renewal or reissuance. Both of these intangible rights were sufficient to pass to the Trustee in bankruptcy and were personal property under the Nova Scotia PPSA, subject to the Ministry of Fisheries' statutory discretion.[74]

How has the enactment of the New *Ontario Limitations Act, 2002* impacted the limitation period for demand note obligations?

When the Ontario *Limitations Act, 2002*[75] (the "New Act") came into force on January 1, 2004, it introduced a two year basic limitation period that commences on the day on which a "claim" is "discovered" or should have been discovered. A "claim" is defined in s. 1 of the New Act as "a claim to remedy an injury, loss or damage". Under s. 5 of the New Act, a claim is "discovered" on the day on which the person with the claim first knew or ought to have known that (i) the injury, loss or damage had occurred, (ii) the injury, loss or damage was caused by or contributed to by an act or omission, (iii) the act or omission was that of the person against whom the claim is made, and (iv) having regard to the nature of the damage, a proceeding would be an appropriate means to seek to remedy it. A claim may not proceed after the expiry of the two-year limitation period.

The reduction of the limitation period from six years under the former *Limitations Act*[76] (the "Former Act") to two years has particular significance for demand promissory notes. Prior to the Ontario Court of Appeal's decision in *Hare v. Hare*,[77] many legal practitioners and commentators believed that a "claim" for a demand note under s. 4 of the New Act would arise only upon a refusal to meet a demand for repayment under the note, since only then would injury, loss or damage occur. If this were the case, the basic two-year limitation period would be calculated from the date of demand (the "Demand Date") and not from the date that the promissory note was entered into (the "Execution Date"), as was previously the case under the Former Act.

In *Hare*, the Ontario Court of Appeal held that the old common law rule continues to apply with respect to demand obligations. In a 2-1 ruling, the Court held that the two-year

[73] *Ibid*. at para. 17.

[74] *Ibid*. at para. 63.

[75] S.O. 2002, c. 24, Sch. B.

[76] R.S.O. 1990, c. L.15.

[77] [2006] O.J. No. 4955 (CA).

limitation period for demand obligations is calculated from the Execution Date, and is restarted on the date on which any payments are made.

In February 1997, Hare loaned $150,000.00 to her son and received a demand promissory note for the sum. The last interest payment under the loan was received in October 1998 and no payments in respect of the note afterwards. Hare made a demand for repayment in November 2004 and, failing receipt of payment, in February 2005, commenced an action against her son for repayment of all sums due. The son moved for summary judgement on the basis that the limitation period had expired. The motion was granted by Justice Minden of the Ontario Superior Court of Justice. Hare subsequently appealed.

The majority decision

The Ontario Court of Appeal dismissed the appeal. The majority held that the limitation period started in February 1997, when the loan was made and the promissory note was executed, and began again in October 1998 when the last partial payment was made. This decision was reached on the basis of the transitional provisions in the New Act and the Court's determination of when the claim was discovered. The majority concluded that since the claim had been discovered before the enactment of the New Act, the six-year limitation period under the Former Act applied. Thus, Hare's claim was statutorily barred, since the limitation period expired in October 2004.

The majority rejected Hare's position that the claim arose on her son's refusal to repay the loan after a demand had been made. First, the majority held that the language of the New Act was not so "irresistibly clear"[78] to be interpreted as changing existing common law rights and established commercial law principles. Second, the majority was concerned that commencing the limitation period on the Demand Date, rather than the Execution Date, would lead to indeterminate liability. For example, if a lender did not make any demands for repayment, the limitation period would not commence and the claim would exist in perpetuity. This result would be contrary to the underlying purpose of limitation periods, namely, the promotion of "finality and certainty in legal affairs".[79] Third, the majority discounted the suggestion that its interpretation of the limitation period for demand obligations could unfairly bar claims before potential plaintiffs were aware of their causes of action, since it is "well-settled" law that a lender of a demand promissory note has the right to immediate repayment of the loan. Accordingly, the majority held that "[t]here is nothing to be discovered by the lender before he or she becomes aware of their claim."[80]

Finally, the majority also considered the effect of the ultimate 15-year limitation period on demand promissory notes. Section 15(2) of the New Act provides that the ultimate 15-year limitation period is triggered by the "act or omission on which the claim is based". In the case of demand obligations, s. 15(6)(c) provides that the day the act or omission on which the claim is based takes place is the day on which the default occurs. However, the word "default" is not

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[78] *Ibid*. at para. 40.

[79] *Ibid*. at para. 41.

[80] *Ibid*. at para. 50.

defined in the New Act. To reduce the potential for indeterminate liability, the majority interpreted "default" to mean "the failure to repay on the day that a demand promissory note is delivered."[81] As a result, the ultimate 15-year limitation period for demand obligations was held to commence on the Execution Date, not the Demand Date.

The dissent

Juriansz J.A., in dissent, interpreted the provisions of the New Act differently. First, he decided that the basic two-year limitation period for demand promissory notes commences on the date of default following a demand for repayment, as opposed to the date the loan is made. Juriansz J. A. reached this conclusion based on his interpretation of the discovery rules in s. 5 of the New Act. He held that the last of the four pre-requisites for discovery in s. 5 of the New Act, which was not present in the Former Act, could only be satisfied when a demand for repayment had been made and refused. This was because, although the creditor may know he or she is *entitled* to commence an action at the Execution Date, only at the Demand Date does the creditor know it is *appropriate* to do so.[82]

Second, in interpreting the ultimate limitation period in s. 15 of the New Act, Juriansz J.A. decided that the word "default" in s. 15(6)(c) must mean something different from the phrase "the day of the act or omission on which the claim is based" in s. 15(2), as to interpret otherwise would make s. 15(6)(c) a tautology.[83] He found that, in the case of demand obligations, the day of default means "the day of default in not performing the obligation to repay a demand loan after a demand has been made".[84] Juriansz J.A. explained that his interpretation acknowledges and accepts the legislative intention to allow the potential for indeterminate liability for demand obligations where no demand is made. In his view, such indeterminate liability is not inconsistent with the overall scheme of the New Act because it already recognizes special situations where no limitation periods apply. In particular, s. 15(6) lists circumstances where the limitation period could run indefinitely and ss. 16(1)(f) and (g) provide that no limitation periods apply to certain other types of proceedings.

Practice Points

The decision in *Hare* has significance for lenders. It now appears that the New Act does not change the commencement date for the limitation period for demand loans. However, since the New Act reduces the length of the basic limitation period as of January 1, 2004, it bars lenders from bringing actions for repayment of demand promissory notes that were executed more than two years ago and on which no payment has been made.

Lenders should be cognizant of the reduced period in which they are able to bring a claim and may want to consider implementing timely and effective systems to diligently monitor

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[81] *Ibid.* at para. 45.

[82] *Ibid*. at para. 80.

[83] *Ibid*. at para. 95.

[84] *Ibid*. at para. 96.

demand loan payments and obtain express written acknowledgements from debtors to restart the commencement of the limitation period. Alternatively, pursuant to the recently amended s. 22 of the New Act, lenders and borrowers may, by agreement made after October 19, 2006, extend the New Act's basic 2-year limitation period. The inclusion of a tolling provision in the demand note extending the limitation period could better protect lenders from the short limitation period applied to demand promissory notes and reduce the risk of their claims being barred.

The Ontario Bar Association recently asked the Ontario Ministry of the Attorney General to amend the New Act to override *Hare*, and expressly provide that the limitation period for a demand obligation begins on the Demand Date.[85]

[85] Patti Shedden, "Financial Services & Insolvency Newsletter - warning there is a two-year limitation for demand notes in Ontario" (Miller Thomson LLP, April, 2007), online at <http://www.millerthomson.com/mtweb.nsf/web_files/kmdd72ct33/$File/Financial_Services_and_Insolvency_April07.pdf?openelement>.