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The Rise of the Unregistered Priority Interest: Significant Priorities Cases in 2020

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The significant priorities cases in 2020 arose in every imaginable context from the sale of residential properties to construction projects to remediating environmental damage. The overarching theme was that most cases dealt with a dispute between lenders' registered security interests and unregistered interests that arose as a result of various statutory trusts or priorities in favour of governments.

The *Construction Lien Act* trust – *Urbancorp Cumberland 2 GP Inc. (Re)*, 2020 ONCA 197

Urbancorp Cumberland 2 GP Inc, (Re) considered the scope and effectiveness of the trust created by section 9(1) of the *Construction Lien Act* (the "**CLA**") (now the *Construction Act*) in an insolvency proceeding. Section 9(1) of the CLA creates a trust in favour of unpaid contractors over the sale proceeds of property where the unpaid contractors improved the property.

The Cumberland Group ("**Cumberland**") was a residential condominium developer. It was granted insolvency protection under the *Bankruptcy and Insolvency Act* (the " **BIA**") and continued under the *Companies' Creditors Arrangement Act* (the "**CCAA**"). Cumberland owned unsold condominium units in a project it constructed. Toro Aluminum, Speedy Electrical Contractors and Dolvin Mechanical Contractors Ltd. (together, the "**Subcontractors**") had supplied work and materials to these units and were owed significant unpaid sums.

The condominium units were ultimately sold during the insolvency proceedings. The Subcontractors claimed that a trust arose over the proceeds from the sale to the extent of the amounts owed to them.

The Monitor brought a motion for a determination of whether the sale proceeds were impressed with a trust in the Subcontractors' favour. The motion judge held that they were not because the Monitor, not the "owners", had control over the sales process and received the sales proceeds. The motion judge concluded that he was bound by the decision in *Re Veltri Metal Products Co.* (2005), 48 CLR (3d) 161 (Ont CA) which had previously rejected a similar argument about a trust created by the CLA.

The Subcontractors appealed the motion judge's decision arguing:

1. that each condominium sale was a sale by the owners because the sale agreements were entered into on their behalf by the Monitor as a representative;
2. that it was the owners' interest in the units that was sold and that the proceeds were received by each of them as owner because they were deposited into bank accounts opened for them;
3. that the proceeds exceeded both the expenses of the sale and the amount of mortgage indebtedness resulting in a positive balance that could constitute a trust fund for their benefit and that, as a result, this case was distinguishable from Veltri; and
4. That a BIA or CCAA proceeding does not prevent the recognition of a s. 9(1) trust.

The respondents argued that the sales were not made "by the owner" given the Monitor's control of the sales process and that the proceeds of sale were not "received by the owner", but rather by the Monitor on behalf of creditors.

The Court of Appeal held that the trust created by s. 9(1) of the CLA can be effective in a CCAA sales process. Under the BIA, a provincial statutory trust granting priority to its beneficiary is ineffective if it does not meet the requirements of a trust under general trust law – certainty of intention, certainty of object, and certainty of subject matter. Under the CCAA, however, even provincial trusts that do not meet those requirements may continue to apply.

Dealing with the paramountcy issue, the Court held that the trust would only be displaced if it conflicted with a specific priority created under the CCAA, such as a DIP charge or the monitor's charge.

The Court of Appeal distinguished the decision in *Veltri* because in that case, the debt to the secured creditors exceeded the purchase price of the assets. Veltri (the owner) had no interest in the proceeds which were entirely subject to the creditors' security interests.

The CRA deemed trust – *Toronto-Dominion Bank v Canada*, 2020 FCA 80

Toronto-Dominion Bank v Canada considers whether a secured creditor who receives proceeds from a tax debtor's property at a time when the debtor owes GST to the Crown is required to pay the proceeds, or a portion thereof equalling the tax debt, to the Receiver General in priority to all security interests.

The tax debtor owned and operated a landscaping business as a sole proprietorship. In 2007 and 2008, the tax debtor collected GST, but did not remit it to the Receiver General.

In 2010, TD Bank extended loans to the tax debtor and his wife. The loans were secured against the couple's property. The bank was not aware of the GST debt owed by the tax debtor.

In 2011, the tax debtor and his wife sold the property and repaid the TD loan from the sale proceeds. Accordingly, TD discharged its security against the property.

In 2013 and 2015, the CRA asserted a deemed trust claim under section 222 of the *Excise Tax Act* against TD Bank on the basis that the proceeds it received from the sale of the property ought to have been paid to the Receiver General up to the amount deemed to be held in trust. TD Bank refused to pay, and the Crown commenced an action seeking the amount of the deemed trust.

The Federal Court of Appeal considered the legislative history of section 222 of the *Excise Tax Act* and similar sections in the *Income Tax Act*, the *Canada Pension Plan* and the *Employment Insurance Act*. Amendments made to the deemed trust provisions in these statutes made it clear that Parliament intended to grant priority to the deemed trust in respect of property that is also subject to a security interest, regardless of when the security interest arose in relation to the time the GST was collected. When the bank lent money and took its security interest, the debtor's property, to the extent of the tax debt, was already deemed to be beneficially owned by the Crown.

TD argued that the trust required a triggering event to crystalize around the assets, similar to the way a floating charge operates. Since TD Bank was not a secured creditor at the time the Crown asserted its claim, the Crown should not have priority. The Court rejected this argument because it ignored the fact that the section conferred a beneficial interest to the Crown. The Court also rejected the argument because prior iterations of the section spoke to a triggering event, but the current iteration did not. The Court found the argument to be inconsistent with prior decisions dealing with the priority of similarly worded sections in the *Income Tax Act*.

The Court also rejected TD Bank's argument that it was a *bona fide* purchaser for value. This argument was inconsistent with previous decisions holding that secured creditors were not comparable to third party purchasers.

Finally, three hypothetical examples were advanced to show the absurdity of granting priority in the circumstances of this case:

1. Lenders would require continuous confirmation from CRA that deemed trust amounts have been paid;
2. The deemed trust ranks in priority to secured creditors but not in priority to unsecured creditors, even though the secured creditor has priority over unsecured creditors; and
3. The CRA argument promotes bankruptcy (where the deemed trust priority does not survive over restructuring alternatives).

The Court rejected all these arguments. The Court held that Parliament made a considered policy choice to prioritize the deemed trust over the interests of secured creditors. Further, lenders could mitigate risk by identifying higher risk borrowers and requiring evidence of tax compliance.

The environmental remediation super-priorities – *British Columbia (Attorney General) v Quinsam Coal Corporation*, 2020 BCSC 640

Quinsam Coal is a follow-up to the Supreme Court of Canada's decision in *Orphan Well Association v Grant Thornton Ltd.*, 2019 SCC 5 ("**Redwater**"). In Redwater, the Supreme Court held that a provincial regulatory regime that imposes cleanup conditions on a licence holder, including a receiver or a trustee, can coexist with the BIA without triggering the doctrine of paramountcy. The receiver was not personally liable for existing environmental obligations, but it was required to use the proceeds realized from the estate to comply with valid orders made by provincial regulators under the applicable environmental regimes.

In *Quinsam Coal*, the respondent, Quinsam Coal Corporation ("**Quinsam**"), owned or leased several properties where coal was mined and shipped. Quinsam's trustee abandoned the properties without fulfilling the closure, reclamation and remediation obligations which were imposed under the *Mines Act*, RSBC 1996, c 293. The Province performed the work which resulted in a significant liability from Quinsam to the Province. Quinsam also owed money to a secured creditor. The issue that the court considered was whether the proceeds from the sale of the assets of Quinsam must be used to fund unfulfilled regulatory obligations before any payment is made to secured creditors. In other words, is there a super-priority for the remediation costs.

The court ruled that the Province did not have priority because, unlike the Alberta legislation that was considered in Redwater, the B.C. *Mines Act* did not expressly make the trustee responsible for the remediation and made the estate liable for remediation obligations. Instead, the *Mines Act* permitted the Province to require security for the remediation costs and gave the Province a lien and charge against the properties for the remediation costs. In addition, the court found that the assets in question were not assets of Quinsam so they would not be subject to any super-priority in favour of the Province.

Despite these differences, the court said that there were aspects of Redwater that could not be ignored and explicitly asked whether the Supreme Court in Redwater intended to create a super-priority for remediation costs. Taken at its highest, the court said, Redwater requires a trustee in bankruptcy or other insolvency professional to use the assets of the estate to satisfy the regulatory obligations imposed on the bankrupt. However, the court declined to answer this question as it was not required to do so in order to resolve the issue in the case.

***Yukon (Government of) v Yukon Zinc Corporation*, 2020 YKSC 15**

Continuing with priorities for environmental remediation, in *Yukon Zinc*, the court considered the priority of the Crown's claim pursuant to section 14.06(7) and (8) of the BIA for remediation costs.

Section 14.06(7) gives the Crown a charge against the real property of a debtor in a bankruptcy, proposal or receivership for any costs of remedying any environmental condition or damage affecting the property. This charge ranks above any security against the property.

Section 14.06(8) provides that, despite subsection 121(1) of the BIA, a claim in a bankruptcy or proposal for the cost of remedying any environmental condition or damage is a provable claim whether the condition or damage occurred before or after the date of the initial bankruptcy event.

In *Yukon Zinc*, the Yukon government held security for some, but not all, of the expected costs to remediate a mine. Of note, the costs had not yet been incurred. Yukon Zinc's secured creditors argued that the Yukon government would only have a secured claim if it incurred remediation costs and the property was then sold. The purchaser would pay for a remediated mine and the secured creditors should not reap the benefit of the increased purchase price. In this case, the remediation costs were still contingent and should not form a charge on the property of the bankrupt.

The secured creditors also argued that the claim created by section 14.06(8) was an unsecured claim. Section 14.06(8) created an exception to subsection 121(1) and subsection 121(1) applied to unsecured claims. The secured creditor argued that this must mean that the claim created is unsecured.

The court held that section 14.06(7) does apply once the Yukon government has incurred costs. The court did not accept the secured creditor's argument that s.14.06(7) only creates an unsecured claim based on the limiting provision in s.14.06(8). Section 14.06(8) only broadens the temporal restrictions set out in section 121 of the BIA (requiring that the debt arise before the date of the initial bankruptcy event) in the environmental regulatory context.

No super-priority for damages resulting from the breach of an eligible financial contract – *Bellatrix Exploration Ltd (Re)*, 2020 ABQB 809

The issue in *Bellatrix Exploration* was whether the CCAA grants the non-insolvent counterpart to an eligible financial contract that has not chosen to terminate the agreement any security or priority for its damages as a result of the debtor's ongoing failure to perform under the agreement.

The CCAA defines certain types of contracts relating to the purchase and sale of derivatives, securities or commodities as eligible financial agreements. Because of the potential risks associated with these types of contracts, non-insolvent counterparties to these contracts get additional rights which are not afforded to other contracting parties.

Two protections are offered to non-insolvent counterparties to an eligible financial contract:

1. the right to terminate the contract and crystalize its losses despite the stay provision of the CCAA; and
2. the right to set-off if the contract itself allows for it.

In *Bellatrix Exploration*, BP Canada Energy ULC ("**BP**") entered into a contract for the short-term sale and purchase of natural gas with the debtor, Bellatrix Exploration Ltd. ("**Bellatrix**"). Bellatrix disclaimed the agreement with BP. BP responded that the agreement was an eligible financial contract and could not be disclaimed. Bellatrix disagreed with BP's position and stopped supplying natural gas.

The assets of Bellatrix were sold and the agreement with BP was not assigned to the purchaser. Bellatrix's first secured creditor sought a declaration that it had a first priority interest in all of the property of Bellatrix and that amounts owing to BP were an unsecured claim. BP sought a declaration that it had a charge over the property of Bellatrix in the amount of the damages it suffered

because of Bellatrix's breach of the agreement.

Reviewing the provisions dealing with eligible financial contracts and the protections granted to non-insolvency counterparties, the court stated that the protections do not compel a debtor to continue to perform an eligible financial contract that has not been terminated nor does the CCAA provide the non-insolvent counterparty with any priority for its claim. Unless the non-insolvent counterparty has a security interest, it is an unsecured creditor and participates in the CCAA proceedings on the same footing as other unsecured creditors.

And now for something completely different – *In the Matter of a Plan of Arrangement of UrtheCast Corp*., 2020 BCSC 2024

UrtheCast considered the application of section 11.2(3) of the CCAA and the court's ability to order that the charge granted to a subsequent DIP lender ranks in priority to the charge of a previous DIP lender.

UrtheCast Corp. and its subsidiaries obtained an Initial Order pursuant to the CCAA, an Amended and Restated Initial Order and then a Revised Amended and Restated Initial Order. These orders included approval of two credit facilities from 1262743 B.C. Ltd. (the "**DIP Lender**") and HCP-FVL, LLC ("**Hale**"). The credit facility from Hale is referred to as the " **Hale DIP Facility**".

The Hale DIP Facility had certain conditions that had to be met before funds would be advanced. UrtheCast Corp. ultimately concluded it would not be able to meet these conditions and brought a motion to approve a replacement DIP facility from Antarctica Infrastructure Partners, LLC (the "**Replacement DIP Facility**"). On the motion, UrtheCast Corp. sought a charge to secure the Replacement DIP Facility in substitution of the charge granted to 126273 B.C. Ltd. and Hale. Hale opposed the priority of the charge for the Replacement DIP Facility.

UrtheCast Corp.'s position was that no funds were advanced by Hale pursuant to the Hale DIP Facility. Hale disputed this position because it had made certain advances to itself on account of costs and expenses that were supposed to be paid by UrtheCast Corp. pursuant to the terms of the Hale DIP Facility and it was owed certain fees such as a commitment fee, a standby fee, and an exit fee.

The parties ultimately arrived at terms that did not subordinate the charge in favour of Hale. However, the court also opined that it could have granted the relief sought by UrtheCast Corp. The court held that the words "…arising from a previous order…" in section 11.2(3) requires that funds be sent to the debtor company for its benefit as opposed to the lender expending funds on other sources or ancillary fees. The court also considered the amount that could potentially be owed to the previous DIP lender in the context of the size of the debtor company. Under these circumstances, the court says the unsuccessful interim lender cannot stand and hold up the entire process.

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