

CCAA Proceedings and Project Bank Accounts

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I. INTRODUCTION

With the number of insolvencies in the construction sector generally remaining at a constant number, there is a growing need for the orderly and efficient administration of insolvency proceedings of construction companies. However, when a construction company initiates insolvency proceedings, there appears to be a degree of uncertainty brought on by the typical stay provisions that prevent creditors from preserving and perfecting lien rights. In addition, and for good reason, trade creditors fear that there may be no prospect of recovering any amount from the insolvent company.

The Comstock Canada Ltd. insolvency proceeding represents a high-water mark in construction insolvencies as it applied recognized insolvency principles, did away with lien proceedings, yet provided an orderly and efficient process for the administration of claims made by Comstock's trade creditors. The court orders obtained were perceived as unusual and perhaps even unconstitutional. However, when the Comstock insolvency is approached from the perspective of trade creditor rights in the course of an ordinary default on a project, the Comstock insolvency proceeding may be viewed as providing an orderly and efficient process for the administration of trade creditor claims and the administration of the insolvent debtor.

II. ORDINARY COURSE DEFAULT

Where there is an ordinary course default on a construction project, the lien legislation in the Provinces and the case authorities provide guidance related to the expectation of recovery of amounts owing to the trade creditors by the defaulting party.

a) Owner Defaults

Where an owner developer defaults so that it no longer makes payments to its contractor and the mortgagee steps in or is about to step in and take control of the project and either sell the property or foreclose, the contractor and its trades will no doubt take steps to preserve and perfect liens. Irrespective

of the state of accounts as between the defaulting owner and the contractor, when a contractor and its trades rely on the lien remedy and the defaulting party is the owner, the liability of the mortgagee with a building mortgage is limited to any deficiency in the holdback that the owner is required to maintain.

If the mortgagee sells the property and the proceeds of sale exceed the outstanding mortgage amount, then the balance of the proceeds of sale may be distributed to the lien claimants. If however, there is a shortfall so that the mortgagee does not recover the amount owing on the mortgage, then the lien claimants can expect to receive no more than the deficiency in holdback that should have been retained by the defaulting owner. The likelihood of any surplus will be determined by the state of completion of the defaulting owner's project.

The contractor can also make a claim for breach of trust under Part II of the *Construction Lien Act* against the company, its officers and directors and those in control of the company. However, the contractor's recovery may be limited depending on the manner in which the owner developer has arranged its business affairs.

Generally, as privity of contract is required for a breach of trust action, this remedy will not be available to the trade creditors as against the owner, however, the trade creditors could avail themselves of this remedy as against the contractor, provided the contractor has received funds from the owner on account of the project and has not paid its trades. If the contractor can prove that it did not misappropriate the trust funds, the subcontractor will not be able to recover any amount from the contractor. In any event, any recovery by the trade creditors under a breach of trust claim may be uncertain and may be affected by a pay-when-paid clause.

If the contractor has provided a labour and material payment bond to the owner, the trades that are claimants may make a claim under the bond. However, if the subcontracts between

the contractor and the trades contain pay-when-paid clauses, the trades' recovery under the bond will likely be limited.

b) Contractor Defaults

Where the defaulting party is the contractor, and assuming that the owner has made all payments to its contractor except for the holdback and the most recent or last draw, where the trade creditors register liens, the owner's liability is limited to the holdback plus any earned and unpaid amount. However the owner is permitted to assert a set-off against the amounts earned by and unpaid to its contractor, but in no event will the set-off affect the owner's holdback liability. As such, assuming the owner has valid set-offs against the earned and unpaid amounts, then the trade creditors can expect to receive no more than the statutory holdback retained by the owner from its contractor.

In addition, under this scenario, even if the subcontractors register liens, their liens may be defeated by Canada Revenue Agency's super-priority.

The trade creditors will be able to avail themselves of the breach of trust remedy and recover from the contractor and its officer or directors or those in control of the contractor will be determined by the extent to which a contractor has arranged its business affairs.

If the contractor posted a labour and payment bond with the owner, the trades will be able to make claims under the bond. The extent of any recovery by the trades will depend on whether there is a "pay-when-paid" clause in the subcontract. The trades may not fully recover from the surety the amounts owed by the contractor.

If the project is not complete and the owner has required that the surety complete the contract under the surety's performance bond, the owner will make available to the surety the balance of the contract funds and have the surety complete the contract. If the balance of the contract funds is insufficient to complete the work, generally the surety will make available the shortfall required to complete the contract. If there is no performance bond, then the owner will retain any earned and unpaid amount (net of holdback) and use those funds along with the balance of the contract funds to complete the work.

c) Subcontractor Defaults

Where the defaulting party is the trade, the suppliers to the insolvent trade are in the same position as outlined above where the defaulting party is the contractor. In this scenario, the contractor will be liable to suppliers and sub-subcontractors of the trade for the holdback and earned and unpaid amounts subject to set-off. The expectation of the suppliers and sub-subcontractors of the insolvent trade is to be paid the holdback.

Just as in the scenario where the defaulting party is the contractor, the CRA's super-priority would take precedence over all the liens of suppliers and sub-subcontractors.

The suppliers and sub-subcontractors will also have the breach of trust remedy, however recovery from the subcontractor and its officers and directors will again depend on any arrangements regarding the business affairs of these parties. In addition, if the trades posted labour and material payment bonds with the contractor, the suppliers will be entitled to make claims under the payment bonds.

d) Expectations

The outcome of a default in the ordinary course serves as a benchmark for the expectation of those involved in a construction project where an insolvent party has commenced insolvency proceedings. Generally, recovery in an ordinary course default is limited to holdback.

III. COMSTOCK'S CCAA PROCEEDING

On June 28, 2013, Comstock and its related companies filed a Notice of Intention to Make a Proposal under section 50.4 of the *BIA* with PricewaterhouseCoopers ("PwC") appointed as trustee. This was followed by the July 2, 2013, Order that appointed PwC as interim receiver of Comstock under section 47.1 of the *BIA* for the limited purpose of borrowing funds which were immediately required to permit the business operations of Comstock to continue. On July 9, 2013, Comstock obtained an order that, in part, provided, that the *BIA* proceeding was continued under the CCAA and that PwC was appointed Monitor of Comstock.

The Initial Order in the Comstock CCAA proceeding included the following stay provisions:

NO PROCEEDINGS AGAINST THE APPLICANTS OR THE PROPERTY

THIS COURT ORDERS that, except as provided in paragraph 17 herein, until and including Thursday, August 8, 2013, or such later date as this Court may order (the "Stay Period"), no proceeding or enforcement process in any court or tribunal (each, a "Proceeding") shall be commenced or continued against or in respect of the Applicants or the Monitor, or affecting the Business or the Property, except with the written consent of the Applicants and the Monitor, or with leave of this Court, and any and all Proceedings currently under way against or in respect of the Applicants or affecting the Business or the Property are hereby stayed and suspended pending further Order of this Court.

NO EXERCISE OF RIGHTS OR REMEDIES

THIS COURT ORDERS that [...] during the Stay Period, all rights and remedies of any individual, firm, corporation, governmental body or agency, or any other entities [...] against or in respect of the Applicants or the Monitor, or affecting the Business or the Property, are hereby stayed and suspended except with the written consent of the Applicants and the Monitor, or leave of this Court, provided that nothing in this Order shall (i) empower the Applicants to carry on any business which the Applicants is not lawfully entitled to carry on, (ii) affect such investigations, actions, suits or proceedings by a regulatory body as are permitted by Section 11.1 of the CCAA, or (iii) **prevent the filing of any registration to preserve or perfect a security interest.** [*Emphasis added*]

The Initial Order in Comstock did not follow the model Initial Order then in use in Ontario with respect to the stay of proceedings. Absent was the usual exception to the stay that permitted lien claimants to preserve and perfect liens and thereafter stay the lien proceedings.

Shortly after the Initial Order was issued, liens were preserved on one of Comstock's projects. The lien claimants were required to explain their conduct that seemingly contravened the Initial Order. Aside from not being aware of the Order, the lien claimants argued that the Order permitted the perfection of "security interests" and as such allowed the preservation of liens. This left unanswered why a creditor with an unperfected security interest was permitted to perfect that security interest while the preservation and perfection of a lien was not included as an exception to the stay. Either the stay applied to all security interests or it did not. Furthermore, the Initial Order did not treat all creditors fairly and equally.

The fact that trades were required to attend at court to explain their conduct highlights the inefficiency of the Initial Order. Trades were left guessing whether the stay applied to them, which meant that each trade would have to apply to lift the stay to permit the preservation and perfection of their lien, a wholly inefficient process. The monitor no doubt saw a need to avoid any stoppage of the flow of funds on the projects that Comstock was completing and rather than looking for a solution, merely dropped the preservation and perfection of liens from the exception in the Initial Order.

This highlights a central concern in Comstock's insolvency, namely the completion of the projects without stopping the flow of funds. While the insolvency court is likely to lift a stay to permit a creditor to preserve its rights, the registration of liens would effectively stop the flow of funds on the project, thereby increasing the likelihood that Comstock would not be able to carry on and no doubt resulting in the bankruptcy of Comstock.

A solution was required to allow the flow of funds unabated on on-going projects while addressing the preservation and perfection of lien rights, while permitting Comstock to complete the projects. The solution was two-fold. First the Monitor obtained the Amended and Restated Initial Order to avoid any ambiguity regarding the stay. The Amended and Restated Initial Order made it clear that the preservation and perfection of liens was prohibited.

Second, the monitor obtained the Lien Regularization Order, which had several aspects to it. First, in the place of liens, the Order created a court ordered charge. Lien claimants were not required to register a claim for lien, but to give notice to the Monitor and others of their lien. The claimants would have a court ordered charge as if they had preserved a lien by registration. Second, owners were protected for the payments they made in accordance with the Order. Third, anyone with an interest in the property and any payor above Comstock was entitled to challenge the timelines and quantum of a lien. Fourth, all liens that were not previously vacated upon the posting of security were vacated from title to the various projects and given a court ordered charge. Finally, the Order did not affect the rights of any person with respect to their trust rights under the construction and builders' lien legislation and did not affect any rights under the labour and material payment bonds or performance bonds or the right to bring a claim for damages or delay except that consent of the Monitor or leave of the Court was required to commence or continue these types of claims.

While the two orders obtained by the Monitor were criticised at the time, the Lien Regularization Order was an elegant solution. It permitted funds to flow on Comstock's

projects into the hands of the Monitor while recognizing liens as if the lien had been preserved and perfected under the applicable construction lien legislation.

It could be argued that substituting validly enacted lien legislation with the creation of a lien charge by way of a court order is outside the broad discretion afforded a court in a CCAA proceeding. However, the result in the circumstances is practical for a number of reasons. First, it protects the rights of lien claimants by recognizing their liens; second, it permits the continued flow of funds so that projects may be completed; and third, it provides a process for the lien claimants to recover what they would have recovered had their lien rights been preserved and perfected under applicable lien legislation. In addition, the Lien Regularization Order left the adjustment of the rights and liabilities of the parties to be determined at a later date, in the event that the parties could not come to a resolution. This process is orderly and efficient, without the necessity of each lien claimant obtaining the consent of the insolvent company, or a court order, to lift the stay to permit the preservation and perfection of lien rights. In addition, the process permitted Comstock to continue operating while recognizing the rights of its creditors. This creative solution, although of concern to claimants, appears to be consistent with the reflections by the Supreme Court of Canada on CCAA proceedings set out in *Century Services*:

When large companies encounter difficulty, reorganizations become increasingly complex. CCAA courts have been called upon to innovate accordingly in exercising their jurisdiction beyond merely staying proceedings against the debtor to allow room for reorganization. They have been asked to sanction measures for which there is no explicit authority in the CCAA. Without exhaustively cataloguing the various measures taken under the authority of the CCAA, it is useful to refer briefly to a few examples to illustrate the flexibility the statute affords supervising courts.

IV. TRUST CLAIMS AND INSOLVENCY PROCEEDINGS

Canadian Courts have repeatedly affirmed that provincial statutory deemed trusts do not defeat a secured party's rights to funds in CCAA or BIA insolvency proceedings. This principle has been reaffirmed with respect to deemed trusts in construction lien legislation in Ontario in *Royal Bank v. Atlas Block*. The result in *Atlas* is consistent with prior authorities on this issue and represents a call to Provincial and Federal legislators that if the trust remedy is to be effective in insolvency proceedings, an amendment is required to the legislation.

In the 1962 decision *John M.M. Troup Ltd. v. Royal Bank*, the Supreme Court of Canada held that provincial lien legislation is competent legislation that does not conflict with federal bankruptcy and insolvency laws. Just over twenty years later, the Supreme Court of Canada considered the effect of s. 67(1) of the BIA on provincial statutory trusts in the decision *British Columbia v. Henfrey Samson Belair Ltd.* The court held that the provisions of s. 67(1) of the BIA do not apply to trusts lacking the common law attributes of trusts. A statutory deemed trust may still meet the requirements for a trust under the principles of trust law, unless and until the trust property is commingled with other funds, at which point it can no longer be traced. The Supreme Court of Canada also noted that interpreting s. 67 of the BIA otherwise in relation to provincial statutory trusts would "be to permit the provinces to create their own priorities

under the Bankruptcy Act and to invite a differential scheme of distribution on bankruptcy from province to province”.

In *Atlas*, the Receiver brought a motion for directions to determine whether the claimant had a trust claim under section 8 of the *Construction Lien Act* over revenue received from *Atlas*' construction customers. The court held that s. 67(1) of the *BIA* only applies to trusts that have all the attributes of a valid trust at common law: intention, subject matter and object. The trust alleged by the claimant lacked the certainty of subject matter because *Atlas* had not segregated the payments received from construction projects and instead commingled them with other funds.

Canada is stuck debating paramountcy and priorities. The trust provisions in construction lien legislation have been sterilized. It appears that the legislators will not take the initiative and address the issue and therefore the private sector should step in and find a solution. The solution may be found in other jurisdictions that are moving to a trust model to protect trades from the insolvency of construction companies by the use of project bank accounts (“PBA”).

V. PROJECT BANK ACCOUNTS

The experience in Australia, which has had prompt payment legislation for several decades, demonstrates that prompt payment legislation does not necessarily prevent insolvencies of construction companies, as insolvencies of such companies in New South Wales are at an all-time high. A move to pass similar legislation in Ontario, which would have entitled contractors and trades to receive progress payments in a timely manner and to suspend work or terminate their contracts if the progress payments are not made, stalled in Committee.

A recent inquiry into construction industry insolvency in New South Wales made two major recommendations: The first relates to the introduction of a construction trust similar to that in Ontario. The second major recommendation was the use of PBAs. Recent commentary concludes that the formal trust created by PBAs is to be preferred over the construction trust because of higher transparency, efficiency and additional protection to contractors, trades and suppliers.

However, construction trusts and prompt payment legislation, although laudable, are not a complete answer. As other jurisdictions move to PBAs, the time has come for Canada to consider their use.

In March 1998, the Law Reform Commission of Western Australia recommended the use of a statutory trust scheme with the trustee segregating the funds in a trust account, separate from its general bank account. The New South Wales Inquiry mentioned above also recommended the use of a segregated trust account. The New South Wales Government responded by introducing legislation that would require retention (holdback) funds to be placed in a segregated trust account. While the Government was prepared to try project specific bank accounts for certain government projects, it was not prepared to introduce the concept of the trust.

In the United Kingdom, government agencies have undertaken a pilot project to introduce PBAs. In a Cabinet Office 2012 briefing document, the Government set out that “Government Construction Board members have committed, over the next three years, to deliver £4bn worth of construction

projects using PBAs.” The Cabinet Office’s guide to implementing PBAs states that a PBA “is linked to a Trust Deed, and provides insolvency protection for the supply chain.” The Briefing Document also identifies other benefits of a PBA as follows:

Simple though the concept is, PBAs directly deliver against a range of the aims of the Government Construction Strategy. By addressing unfair payment practices, benefits will accrue to the whole supply team, by ensuring transparency of and certainty of payment. In particular, for the SMEs down the supply chain PBAs will protect their often very fine margins, obviate the need for unnecessary borrowing and can lead to a much more balanced trade environment, hence supporting growth. Cost savings accrue from supply chain members not having to chase payment or have to finance lengthy credit periods. PBAs eliminate payment disputes and the costs associated with them (which ultimately feed back into costs for the client). They also help the supply chain concentrate on the job in hand and reinforce or facilitate team working, increased trust leads to greater collaboration, which in turn incentivises innovation.

PBAs have also been implemented in Northern Ireland. The guidance note on PBAs issued by Northern Ireland expressed similar benefits: “Insolvency of a Main Contractor often leads to a domino effect in the supply chain where, upon entering administration, its Subcontractors become exposed to the risk of insolvency.”

Common Law Trust Status

A PBA is a “ring fenced” bank account into which the owner makes payment and from which payments are made to the contractor and the trades. The significance of the PBA is that it has trust status and that its beneficiaries are the contractor and the subscribing trades and suppliers.

The trust status of a PBA is established by a series of agreements, or trust deeds. The Northern Ireland model, for example, requires the owner and the contractor jointly to open the PBA, execute a trust deed related to the account, provide sample authorized signatures to the bank and the owner, contractor and trades or suppliers execute a “Joining Deed”.

Under the UK model, similar trust deeds are executed by the parties. The UK model permits a Dual Authority account where the owner and the contractor are joint trustees or a Single Authority account where only the contractor is the trustee. Existing trades sign the trust deed and new trades execute a joining deed. Where the Dual Authority account is used, the owner and contractor have to both authorize the payment. Under the Single Authority model, after the progress payment is agreed upon, the contractor authorizes the bank to pay the contractor and the trades. Where an owner has cut back the draw, all payments to the contractor and the trades are reduced pro-rata, although the contractor has the option of topping up the account.

The End of Priority Disputes

If owners required PBAs in Canada, with trust deeds, the insolvency of contractors may be nothing more than an inconvenience. As at the date of the insolvency, the owner could value the work, pay any additional amount owed for the work to date into the PBA and have the trades and suppliers

paid the amounts owing to them from the PBA. This would avert or minimize the risk of liens. The owner would be holding the balance of the contract funds and use these funds to complete the project with either a new contractor or the insolvent contractor. If the owner proceeded to complete the work with the insolvent contractor, the monitor or the trustee would be required to sign the trust deed for the PBA. Simply put, issues of priority to the funds would vanish as the funds would be held in a trust account that meets the elements of a common law trust.

VI. CONCLUSION

The Comstock Lien Regularization Order was a good start to achieving a level of orderliness and efficiency to address varied legal rights in insolvencies. However, the priority disputes in insolvency proceedings can be relegated to a memory with the use of PBAs where a trust that satisfies the elements of a common law trust is established by the use of PBAs. As a result of the failure to act by the legislatures, the push for PBAs will have to come from the private sector.

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