BAR REFRESHER '87

Insolvency

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INTRODUCTION

With one change, the following is an essay from which I delivered a short talk at the 1987 Bar Refresher course. Most of the errors in my original draft of this essay were corrected by my colleague, Brian Stilwell. One escaped his attention and mine. I am grateful to Robert MacKeigan, Q.C., for pointing out to me that the provisions respecting a statutory lien for income tax deductions come into effect on proclamation and not assent. I have corrected the essay to reflect this.

The Latest in Statutory Liens: Income Tax Withholdings

Statutory devices for the protection of various debts in priority to secured creditors are of concern when loans are made and when they fail. The proliferation of these devices continued in 1986 when the legislation consequential upon the May, 1985 budget recieved assent: S.C. 1986, c.84, s. 118. Subsection 227(5) of the Income Tax Act has been amended to improve the deemed trust respecting income tax withholdings effective the date of the budget, May 23rd, 1985 and subsections 227(10.2) to (10.8) have been enacted to create a statutory lien protecting income tax withholdings effective on proclamation. A proclamation has not yet been made. Identical protections now obtain in respect of U.I.C. and C.C.P. deductions: Unemployment Insurance Act, S.C. 1971, c. 48, s. 71 as amended by S.C. 1986, c. 6, s. 132 and Canada Pension Plan Act, R.S.C. 1970, c. C-5, s. 24 as amended by S.C. 1986, c. 6, s. 135.

The old subsection 227(5) of the Income Tax Act was dealt with by the Supreme Court of Canada in Dauphin Plains Credit Union Ltd. v. Xyloid Industries Ltd., (1980), 33 C.B.R. (N.S.) 107 (S.C.C.), where it was held that the deemed trust for unremitted tax deductions withheld from employees was not impressed upon assets later incumbered by a floating charge. The amendments deem the amount due for withholdings to be held separate from the rest of the employer's assets; in effect the deemed trust enjoys a deemed tracing. Therefore, unremitted withholdings have priority over subsequent fixed charges and subsequently crystalized floating charges. The provision has application notwithstanding the Bankruptcy Act.

The statutory lien would have priority over all charges except security given to a seller for the balance of a purchase price and lease related security. The lien secures all unremitted withholdings deducted during the 90 days preceeding assessment or the appointment a receiver, trustee or such. The lien is not affected by bankruptcy.

It appears that the Department of National Revenue and the Superintendant in Bankruptcy have entered into an agreement whereby the trust claims of the department

might be postponed to trustees fees and expenses: Houlden and Morawetz, Bankruptcy Law of Canada, p. 51-53. The amendments for the statutory lien met with great opposition from some lenders and there is speculation that the proclamation may never be made.

The following is a catalogue of statutory liens and similar devices known to the writer including his unworthy opinions as to their priority and the effect of bankruptcy upon them. For some reason I have excluded mechanic's, warehouseman's and innkeeper's liens, distress rights and the like.

legislation	debt	priority	affected by bankruptcy
Assessment Act S.N.S. 1977, c. 22, s. 153 and 25C	real estate, change in use and recreational property taxes	land only, priority over all grants and mortgages including earlier ones ("super secure")	no
Assessment Act, S.N.S. 1977, c. 22, s.7, 134, 135, & 139	business occupancy tax	no lien. Duty on person enforcing chattel security to pay current years tax.	yes
Municipal Act, R.S.N.S. 1967, c. 192 as amended by S.N.S. 1977, c. 36 and S.N.S. 1978, c. 23, s. 203A, 203B, 203C	pollution control charges, sewer charges, trunk sewer tax	charge on land only, super secure	no
Power Commission Act, R.S.N.S. 1967, c. 233, s. 62	value of power consumed in 90 days	super secure.	yes
Worker's Compensation Act. R.S.N.S. 1967, c. 343, s. 144	workers compensation assessments	super secure	yes
Labour Standards Code, S.N.S. 1972, c.10,s.84	order for wages	super secure	yes

Labour Standards Code, S.N.S. 1972, c.10, s.34	vacation pay	deemed trust and super secure lien	yes yes
Health Services Tax Act, R.S.N.S. 1967, c. 126, s.23 and s.9 as amended by S.N.S. 1982, c.27 s.7	health services taxes	lien with priority only over subsequent charges and subsequently crystalized floating charges see also duty regarding bulk sales	yes
Pension Benefits Act, S.N.S. 1975, c. 14, s. 20A as enacted by S.N.S. 1977, c. 74, s. 4	deductions for a private pension plan	deemed trust, but not deemed separate, unsecure	na
Ditches and Water Courses Act, R.S.N.S. 1967, c. 78, s. 9(2) and s. 14	engineer's fees and other costs	charge on land of person assessed, no priority over earlier charges	no
Fire Prevention Act, S.N.S. 1976, c. 9, s. 17	expenses of carrying out fire marshall's order	land of owner only, super secure	no
Canada Pension Plan Act, R.S.C. 1970, c.C-5, s.24 as amended by S.C. 1986, c. 6, s. 132(3)	C.P.P. deductions	as with income tax withholdings	no
Unemployment Insurance Act, S.C. 1971, c.48, s. 71 as amended by S.C. 1986, c. 6, s. 135(2)	U.I.C. deductions	as with income tax withholdings	no
Customs Act, R.S.C. 1970, c. C-40, s.102	customs duties	lien on the goods imported, no priority over earlier charges	yes

Excise Act, R.S.C. 1970, c. E-12, s.113	excise taxes, duties and penalties	lien on certain stock in trade and equipment, no priority over earlier charges.	yes
Excise Act, R.S.C. 1970, c. E-12, s. 52(10) and (11)	duties	prescribes a method for payment of the tax portion of accounts receivable in priority to an assignment of the debt	yes
Financial Administration Act, R.S.C. 1970, c. F-10, s.2 and s.47 as amended by S.C. 1980-81, c.170, s.13	deductions to purchase "securities" such as Canada Savings Bonds	deemed trust, priority like health services taxes	no
Income Tax Act, R.S.C. 1952, c.148, s. 227 as amended, particularly as amended by S.C. 1986, c.84, s. 118	deductions and other withholdings	see above regarding deemed trust and statutory lien	no
Income Tax Act, R.S.C. 1952, c.148, s. 153 (1.3) and 227.1 (1) as amended, by S.C. 1980-81-82-83, c. 48, s. 86(2) and by S.C. 1983-84, c. 1, s. 100	deductions other withholdings	directors liability (s.227.1) and trustee or receiver's liability where past due wages are paid (s.153)	no

Deemed Trusts in the Wake of Deloitte, Haskins and Sales Limited v. Workers' Compensation Board et al. (1985), 55 C.B.R. (N.S.) 241 (S.C.C.).

The order of payment for ten classes of creditors out of the realization of a bankrupt's property is established by subsection 107(1) of the Bankruptcy Act. The last class of these "preferred creditors" is paragraph 107(1)(j) "claims of the Crown...in the right of Canada or a province, pari pasu notwithstanding any statutory preferance...". Subsection 107(1) is expressed to be "subject to the rights of secured creditors" and section 47 excludes property held in trust by the bankrupt.

At one time it seemed settled that provincial statutory liens and deemed trusts for prefered debts were as effective in bankruptcy as otherwise, statutory liens fell within the "subject to" provision and deemed trusts excluded an artificial portion of the property of the bankrupt from the realization, the portion being the beneficial property of the creditor.

Re Bourqualt; Deputy Minister of Revenue v. Rainville (1980), 33 C.B.R. (N.S.) 301 (S.C.C.) held that a provincial statutory lien securing a Crown debt is of no force in a bankruptcy. The decision turned on s. 107(i)(j) and, particularily, the French version of it. The Deloitte, Haskins and Sells Case extended Bourqualt to all provincial statutory liens securing any of the ten classes of preferred creditor. Justice Wilson, who spoke for the majority, gave Bourqualt its widest possible meaning: provincial legislation validly creating a lien protecting a preferred debt is not to be interpretted as having operation in bankruptcy so as to alter the scheme of distribution established by subsection 107(1).

As so often happens, the answering of one question raised new ones. Among them: Does bankruptcy have the same effect on statutory deemed trusts as it does on statutory liens?

The very broad approach taken by the Supreme Court of Canada to the question of statutory liens in bankruptcy casts doubt upon the negative answer to the question

about deemed trusts given by the appeal courts in Ontario and Saskatchewan after Bourqualt but before Deloitte, Haskins & Sells : Re Phoenix Paper Products Limited (1983), 48 C.B.R. 113 (O.C.A.); Todosichuck et al v. Marchenski Lumber Co. Ltd. (1985), 56 C.B.R. (N.S.) 206 (S.C.A.). So do the favourable references in the highest court's latest judgment to the decisions of former Chief Justice Cowan and Justice Jones in Re Black Forest Restaurant Ltd. (1981), 37 C.B.R. (N.S.) 176 (Cowan, C.J.T.D.) affirmed by 38 C.B.R. (N.S.) 253 (N.S.S.C., A.D.), which held that the labour standards lien and deemed trust for vacation pay are avoided by bankruptcy (but did so without analyzing the special issues which are supposed to pertain to deemed trusts). We now have the advantage of the opinion of the Manitoba Court of Appeal. In the as yet unreported decision, Clarkson Gordon Inc. v. Province of Manitoba (1986) unreported (M.C.A.), deemed trusts protecting wages and private pension deductions were held to be inapplicable in bankruptcy. The court drew a distinction between trusts such as those established by some builders lien legislation and the more artificial deemed trust; the former are excluded from property of the bankrupt by section 47 of the Bankruptcy Act but the later are caught by the principle stated in Deloitte, Haskins & Sells.

Another question in the wake of Deloitte, Haskins & Sells is: does bankruptcy defeat a statutory lien for a simple unsecured debt (as would normally be paid under section 112 of the Bankruptcy Act) or is preference a particular curse? And yet another question, a rather ingenious and disturbing one, is raised by Professor John Williamson in an article at 60 C.B.R. (N.S.) 97: does bankruptcy avoid the statutory lien or does it pass the benefit of the lien to the trustee?

Farm Debt Review Act, S.C. 1986, c. 117

The Farm Debt Review Act received assent on August 5th, 1986. The act establishes Farm Debt Review Boards and is designed to facilitate the making of arrangments between farmers and their creditors.

A farmer who is not insolvent but who is experiencing financial difficulties may apply to the board, who will advise the farmer, meet with his creditors and assist both "to enter into an arrangement" (sections 16 to 19).

The board has powers to stay proceedings as regards an insolvent farmer (sections 20 to 32). The farmer must apply to the board, naming his various creditors. The board then notifies the creditors who are thereby prevented, for a period of thirty days, from realizing on security, taking possession of property or pursuing ordinary remedies. The period may be extended as many as three times, at thirty days each. The board is required to appoint a guardian of the farmer's assets, who may be the farmer himself. During these periods a "review panel" appointed by the board must meet with the farmer and his creditors "for the purpose of facilitating an arrangement between them". If an arrangement is made the board may appoint a "licensed trustee" to carry out duties under the arrangement.

Section 22 prohibits a secured creditor of a farmer from realizing on security unless the creditors notifies the farmer of his intention so to do and of the farmer's right to make application under the act. The act binds the crown in either right, so its seems that the Farm Loan Boards would have to observe it. The notice must be delivered at least fifteen business days before the creditor takes any action. The required forms may be obtained from the Farm Debt Review Board, P. O. Box 1800, 35 Commercial Street, Suite 200, Truro, Nova Scotia B2N 5E5.

Necessity For Proof of Claim By A Secured Creditor

Section 59 of the Bankruptcy Act requires persons claiming "any property, or interest therein, in the possession of the bankrupt" to lodge a proof of claim with the trustee. Section 174 makes it an offence to remove such property from the possession of the bankrupt except after the proof has been lodged and thirty days have elapsed or written permission has been secured from the trustee. However, it is not uncommon for a secured creditor to seize mortgaged items of property from a bankrupt mortgagee without delivering a proof of claim. Perhaps these creditors have relied on the decisions which seem to distinguish a "security interest" from a "proprietary interest" in interpreting section 59: Re Festival Singers of Canada (1980), 32 C.B.R. (N.S.) 193 (O.S.C.) and Re Shibou (1982), 42 C.B.R. (N.S.) 132 (M.Q.B.) but see also section 2 and Re Stephenson (1983), 50 C.B.R. (N.S.) 18 (B.C.S.C.). Where the bankrupt holds an item of property pursuant to a lease, on a pawn, as conditional purchaser or, as mortgagee in possession, the person entitled to the property would move to file a claim; but a mortgagee would not have to do so.

Many were surprised when the Bank of Montreal was prosecuted respecting the seizure of a mortgaged chattel where the bank had not delivered a proof of claim: R. v. Bank of Montreal (1985), 53 C.B.R. (N.S.) 287 (M. Prov. J.), affirmed (1986), 58 C.B.R. (N.S.) 45 (M. Dist. Ct.), reversed (1986), 60 C.B.R. (N.S.) 169 (M.C.A.). Both the provincial judge and the district court were of the view that section 59 applies to a mortgagee. The court of appeal set aside the conviction but did so on the ground that the bank's assignee, not the bank itself, had made the seizure. The appeal court did not have to consider the general issue, so it did not.

The arguments advanced for excluding secured creditors from the operation of section 59 face three serious difficulties: nothing in the provisions for ordinary proof by a secured creditor, sections 99 and 100, conflicts with section 59; the language in

subsections 59(2) and (4) "lien, right, title or interest of the claimant" is ordinarily inclusive of a mortgage, and; so is the definition of "property" in section 2.

At trial the bank had called three independent trustees in bankruptcy to show that it was not their practice to require section 59 proofs of claim from secured creditors. That would seem to have been the approach in this Province also. Secured creditors might now be well advised not to seize mortgaged property from a bankrupt without getting permission in writing from the trustee or waiting thirty days after having delivered a proof of claim.

Foreclosure

An amendment was made on September 27th, 1986 to Civil Procedure Rule 51.05 so that prothonotaries may grant orders "where the order is applied for ex parte and it purports to be an order ... confirming a sheriff's report when not combined with an order for deficiency judgment". Since the amendment of rule 47, which provides that applications for deficiency judgments must be brought within six months of sale, it has not been necessary to couple the confirmation application with an application for leave to apply for a deficiency judgment at a later date.

Some have argued that failure to acquire a deficiency judgment may compromise a subsequent action on a guarantee of the mortgage debt. The extinguishment of the mortgagee's right to a judgment amounts to an extinguishment of the debt and a discharge of the guarantee; so the argument goes. The argument is scotched by Bank of Montreal v. Fifth Avenue Investments (1985), 74 N.S.R. (2d) 181 (A.D.). The guarantee in question had actually been reduced to judgment but Chief Justice MacKeigan indicates that while a mortgagee may be barred from pursuing the principal obligant it is not necessarily barred from pursuing other remedies.

Although awards of solicitor and client costs seem to be normal in receiverships, several attempts to secure such an award on a foreclosure have failed. The latest failed attempt is Theoharopoulos v. Pillitteri (1986), unreported (Nathanson, J.) where Justice Nathanson decided that the discretion to award costs overrides contract and, in any event, the provision in question was not so craftfully written as to compel solicitor and client costs. An additional reason might be that such is not permitted under subsection 8(1) of the Interest Act, R.S.C. 1970, C. I-18 or so the decision in Sun Life Assurance Company of Canada v. Ferland (1974), 11 N.R. 32 (S.C.C.) seems to suggest.

Reasonable Notice Before Seizure

It has been argued that the decision of the Supreme Court of Canada in R.E. Lister Ltd. v. Dunlop Canada Limited (1982), 41 C.B.R. (N.S.) 272 (S.C.C.), which held that reasonable notice must be given to a debtor before a demand debenture is enforced, has no application to a term debenture. The decisions leading up to Lister v. Dunlop all concerned demand debts and the argument draws some strength from the fact that the earliest decision in this line of cases was founded upon an interpretation of payment "immediately upon demand in writing" as meaning within a reasonable time. Indeed, the distinction between term debt and demand debt is a substancial one: where payment is made on terms the debtor knows when he must raise the funds but where payment is on demand he does not know when he may have to do so.

The argument carried little weight with the New Brunswick Court of Appeal in Roynat Ltd. v. Northern Meat Packers Ltd. et al. (1986), 60 C.B.R. (N.S.) 1 (N.B.C.A.). Roynat lent money to Northern repayable on terms and Roynat took a debenture as security for the loan. Pursuant to another debenture, the Bank of Montreal appointed the Clarkson Company receiver for Northern. Upon hearing of this Roynat also appointed Clarkson. The receiver took possession of the assets charged to Roynat. No warning was given by Roynat to Northern. The trial judge whose decision is reported in (1985), 63 N.B.R. (2d) 41 (Q.B.) and the appeal court both held that, in the absence of notice the seizure and subsequent sales where illegal and Roynat was liable to Northern for conversion.

The argument about term debts was made. Chief Justice Stratton said that he did not think that the Supreme Court of Canada intended to confine the requirement for reasonable notice to demand debentures and he noted that the Supreme Court had made reference to "debt-evidencing or creating documents as including in all cases the requirement of reasonable notice for payment", R.E. Lister Ltd. v. Dunlop Canada

Limited, supra., p. 288. The reply to this is that where term debts are concerned the debtor always has plenty of notice for payment because he has agreed to the payment date well in advance. That reply is still available even in New Brunswick because the court went on to suggest that no serious default was available to Roynat. Perhaps a default in payment, as opposed to the default constituted by another creditor appointing a receiver, would have led to a different result.

It may be that by a properly drafted debenture a debtor can contract out of its right to reasonable notice. There is some discussion of this subject in R.G. Marantz, Q.C. "Tactics For Survival" (1986), 1 B. & F.L.R. 1.