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Kicking A-1 Asphalt to the Curb

Court of Appeal brings Statutory Lien Trusts back from the Dead

By R. Graham Phoenix & Christophe Shammass

In recent years, trial Courts in Ontario walked a thin line: holding that the statutory trust established by the Ontario Construction Lien Act (now the Construction Act) ("CLA") does not survive a bankruptcy. Following such reasoning, those who would otherwise be entitled to a priority payment through the trust were rendered ordinary unsecured creditors in bankruptcy.

However, in a recent decision, a unanimous five-judge panel of the Court of Appeal has held that statutory trusts created by the CLA can be considered trusts for the purposes of the Bankruptcy and Insolvency Act ("BIA"). In so doing, the Court of Appeal upended a consistent line of trial-level jurisprudence, reviving a battleground in bankruptcy proceedings where beneficiaries of construction trusts will again argue that trust funds are outside bankruptcy estates and not available for distribution to ordinary creditors in bankruptcy.

The decision has significant implications for construction and bankruptcy practitioners as well as any client involved in the construction world.

Facts

A-1 Asphalt Maintenance Ltd. ("A-1") entered into bankruptcy on December 22, 2014. At the time, A-1 had four ongoing paving projects on which it had not been paid. At the direction of the bankruptcy judge, the Receiver for A-1 created a paving projects account to which any payments on the four projects would be deposited. Over time, the Receiver received \$675,372.27, which it deposited in the paving projects account. It was agreed that the funds received by the Receiver were impressed with a trust created by the CLA. The motions judge rejected that these funds were subject to a trust for the purposes of section 67 of the BIA, holding that a statutory trust can only be valid in proceedings under the BIA if it met the legal test for a "true trust" under the law and the statutory trust in this case failed to do so. The potential trust beneficiary appealed.

Issue

The issue before the Court of Appeal was whether the funds received by the Receiver and impressed with a statutory trust were excluded from distribution to A-1's creditors pursuant to the *BIA*. Specifically, the Court of Appeal considered whether the motion judge's determination that the statutory trust was not a subsisting "true trust" under the law was correct.

Decision

Justice Sharpe, writing for the unanimous five-judge panel of the Court of Appeal, first confirmed that, to qualify as a "trust" for the purposes of the *BIA*, the statutory trust must satisfy the three elements of certainty of intention, certainty of subject matter and certainty of object.

Thereafter, the Court tackled a number of persistent issues that have marked the interaction of the statutory trust provisions of the *CLA* and the *BIA* over the years, holding:

- *The statutory trust is not invalidated simply because the BIA (a federal statute) has been invoked* – the trust provisions of the *CLA* relate to the provincial jurisdiction over property and civil rights and the effects that the provisions have in the event of bankruptcy are incidental to the provisions' provincial pith and substance.
- *The statutory trust does not inherently conflict with the scheme distributions to creditors under BIA* – there was no conflict between the *CLA* and the *BIA* because (a) the Supreme Court had previously recognized that the provinces could deem a statutory trust to arise and (b) the *CLA* did not create a general priority over all of the bankrupt's assets but rather impressed a specific property with a trust (i.e. the funds owing to or received by the contractor or subcontractor).

The Court of Appeal determined that, in the circumstances, the statutory trust created by the *CLA* met the test of a "true trust" under the law:

- *Certainty of Intention* – satisfied by the stated intention of the trust provisions of the *CLA*;
- *Certainty of Subject Matter* – satisfied by the choses in action arising out of the debts on the construction project; and
- *Certainty of Object* – satisfied by the express terms of the *CLA* (i.e., "for the benefit of subcontractors, etc.).

Significantly, the Court of Appeal held that the commingling of funds in the account did not invalidate the certainty of subject matter. Previously, such an argument had consistently resulted in trusts being invalidated where an account is used for more than trust funds.

The Court of Appeal's reasoning on commingling of funds departed from recent trial-level decisions, relying on a previous Court of Appeal decision in *GMAC Commercial Credit Corporation v TCT Logistics Inc.* ("*GMAC*"), that had held that commingling will be fatal to the existence of a trust. The Court of Appeal distinguished *GMAC* on the basis that the statute at issue in *GMAC* did not create a trust but rather created an obligation to hold funds in trust. Where those obligations were not carried out, no trust could come into existence.

In the context of the statutory trust created by the *CLA*, the Court of Appeal stated that it is only when the commingling is accompanied by conversion and tracing becomes impossible that the required element of certainty of subject matter is lost. In other words, the normal rules of tracing will apply to determine whether a statutory trust can survive bankruptcy as a "true trust".

Takeaways

For those in the construction industry, the Court of Appeal's decision can only be viewed as positive. The Court of Appeal recognized the important protections that the trust provisions of the *CLA* give contractors and subcontractors and has confirmed that, where the three elements of a trust are established, trust funds will be preserved in the event of bankruptcy. Moreover, potential beneficiaries are empowered to trace such funds in a manner unlike the past.

For those practitioners in the bankruptcy world, the traditional "processing" of claims in construction cases just became more nuanced. More than ever, the facts of how a construction project is administered and how funds are collected are critical. Not only will this impact creditors and the potential beneficiaries of possible *CLA* trusts, but so too will it impact trustees and receivers, who must now be alive to the fact that potential personal liability may exist should trust funds not be managed properly. It will be critical to seek advice and directions of the Court where uncertainty exists.

This decision is squarely limited to statutory trusts established under the *CLA*. However, it is not a stretch to imagine similar arguments in the context of other provincial statutes or, should the provincial government wish, a redrafting of certain legislation to fit other statutory trusts within the Court of Appeal's reasoning. Still, the decision does not mean that any such statutory trust exists in bankruptcy. It means that such statutory trusts *may* exist. It will fall on the stakeholders and their professionals, in both the construction and bankruptcy world, to determine precisely where those worlds intersect.

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