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Donâ€™t Believe What Youâ€™ve Heard: Provincial statutory trusts do survive bankruptcy

A five-judge panel of the Court of Appeal for Ontario has upset the long-standing conventional wisdom among bankruptcy and insolvency practitioners in Ontario about the fate of provincially-created statutory trusts in bankruptcy.

In reasons released on January 14, 2019, Sharpe J.A. on behalf of a unanimous five-judge panel, overturned a decision of the Commercial List in *The Guarantee Company of North of America v Royal Bank of Canada* and affirmed that provincially created statutory trusts do qualify as trusts pursuant to section 67 of the *Bankruptcy and Insolvency Act* and thus preserve assets from distribution to ordinary creditors in bankruptcy, provided that the statutory trust aligns with general principles of trust law. In particular, the Court held that section 8 of the Ontario *Construction Lien Act* creates a valid trust that will survive bankruptcy provided that the property subject to the trust remains indentifiable and traceable.

A-1 Asphalt filed a Notice of Intention to make a proposal under the *BIA* in November, 2014 and was deemed bankrupt one month later. At that time it was undertaking four major paving projects for the City of Hamilton and the Town of Halton Hills. At the time of the bankruptcy A-1 was owed nearly $700,000 by the municipalities for work already completed. The municipalities were directed by the Court to pay these funds to A-1's Receiver ("the Funds").

The Receiver brought a motion for directions to resolve a dispute regarding entitlement to the Funds between Guarantee Company of North America ("GCNA") and Royal Bank of Canada ("RBC"). GCNA asserted that the Funds were trust property pursuant to section 8 of the *CLA.* GCNA had paid nearly $1.9 million in bond claims to A-1's *CLA* lien claimants and was subrogated to those claims. RBC asserted that it was entitled to the Funds as A-1's secured creditor pursuant to a general security agreement. In response to a Notice of Constitutional Question served by the Receiver, the Attorney General of Ontario intervened.

The motions judge delivered a handwritten endorsement and held that GCNA had failed to establish a trust claim and that the Funds were not excluded from A-1's estate available for distribution to creditors pursuant to the *BIA.* In reaching this conclusion, the motions judge concluded that:

- the Funds were not segregated by the municipalities prior to payment to the Recevier; and
- notwithstanding the accounting maintained by the Receiver post-bankruptcy, A-1 (prior to its bankruptcy) had no established means to hold receipts separate from other funds in order to maintain their character as trust funds.

The Court of Appeal for Ontario reversed this ruling and clarified the applicable principles in a very important decision that will have significant implications for participants in the construction industry and lenders.

First, the Court rejected the lender's position that section 8 of the *CLA* was, in pith and substance, an attempt to reorder priorities in bankruptcy and therefore unconstitutional. The Court clarified that the section 8 trust was properly a matter of property and civil rights and therefore valid provincial legislation. The Court was clear that provincial legislation can properly satisfy the certainty of intention requirement for a valid trust pursuant to general principles of law. The doctrine of paramountcy was not engaged and the Court specifically rejected the suggestion that the *CLA* trust frustrates the purpose of the *BIA*.

Second, the Court held that the *CLA* trust did not purport to create a general priority over all of the bankrupt's assets but was specific to the debts owed to bankrupt by the owner municipalities to the extent of any unpaid obligation to subcontractors (i.e. here GCNA through its subrogated rights).

Finally, the Court rejected a line of recent jurisprudence from the Commercial List (eg *Bank of Montreal v Kappeler* and *Royal Bank of Canada v Atlas Block Co.*) suggesting that commingling of trust property is fatal to the certainty of subject matter requirement for a surviving trust at law. Expanding on its own decision in *Re Graphicshoppe*, the Court held unequivocally that "commingling of trust money with other money can destroy the element of certainty of subject matter, but only where commingling makes it impossible to identify or trace the trust property". In doing so, the Court resolved lingering confusion concerning the scope and application of its decision in *GMAC Commercial Credit Corp. v TCT Logistics Inc*.

In the result, the Court held that provincial statutory trusts can and will survive bankruptcy where they exhibit the features of a trust according to general principles of law, and that the terms of the a provincial enactment can determine the question whether the three certainties are satisfied.

This decision has significant implications for participants in the construction industry and bankruptcy and insolvency practitioners alike. The Court of Appeal has upset conventional wisdom among certain bankruptcy practitioners that deemed trusts are categorically invalid after bankruptcy. In doing so, the Court has protected the integral nature of the provincial scheme of holdbacks, liens and trusts, designed to protect the rights and interests of those engaged in the construction industry and to avoid unjust enrichment of those higher up in the construction pyramid. The Court has made it clear that these protections are important and remain undisturbed after a bankruptcy occurs.

Note: Lenczner Slaght litigators, Matthew B. Lerner and Scott Rollwagen, acted for the successful appellant in this landmark decision.