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• EQUITABLE SUBORDINATION IN CANADA— WAITING FOR THE RIGHT FACTS •

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What does the U.S. doctrine of equitable subordination have to do with Canada? Superficially, the answer may be: not much. But for many financing and insolvency professionals here in Canada, there remains a palpable sense that the U.S. doctrine will eventually, if not inevitably, find its way fully across the U.S. border into Canada. So, perhaps the more appropriate response really ought to be: not much, at least not yet! It is because of this anticipation that it is worthwhile, from time to time, to summarize the central aspects of the U.S. doctrine and to determine its current level of acceptance here in Canada.

• In This Issue •

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The U.S. Doctrine in Brief

Under the U.S. Bankruptcy Code, U.S. courts may apply equitable principles to remedy creditor misbehaviour, including by subordinating certain creditor claims—both secured and unsecured—to the claims of lower-ranking creditors. But, because the remedy disregards the otherwise freely negotiated arrangements of transacting parties, the remedy is considered an extraordinary one, which is to be utilized only sparingly.[1] Three conditions must be satisfied before a subordination will be imposed by the court:

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(1) the creditor whose claim is to be subordinated must have engaged in some form of inequitable conduct, (2) the misconduct must have resulted in injury to the bankrupt's other creditors or conferred an unfair advantage upon the misbehaving creditor, and (3) the subordination must otherwise be consistent with the provisions of U.S. bankruptcy legislation.[2] As a result, the doctrine is usually applied in cases involving some element of fraud, unjust enrichment, breach of fiduciary duty, or other inequitable conduct, where there is otherwise some connection between the creditor's misconduct and the injury or disadvantage suffered by the aggrieved creditors.[3]

The U.S. doctrine is most often applied to sanction the activities of "insiders", for example, the activities of parent corporations or other persons related to the bankrupt who have attempted (improperly) to gain a leg-up on other creditors. Due to the non–arm's length nature of the relationship, insider conduct will always be subject to closer scrutiny by the courts.[4] For "non-insider" cases, on the other hand, where no fiduciary duty is owed to the bankrupt, and the impugned creditor otherwise deals at arm's length with the bankrupt, the doctrine is applied much more restrictively and generally requires misconduct that is "gross and egregious".[5] Specifically, the doctrine is usually applied when the arm's length creditor has "dominated" or "controlled" the bankrupt in some way so as to gain an unfair advantage over other creditors. In the absence of domination, the doctrine may also be applied where the arm's length creditor has actually defrauded another creditor. Not surprisingly, much of the impugned conduct in both insider and non-insider cases occurs on the eve of the debtor's insolvency.

A good example of non-insider subordination is the case of *In re American Lumber Co.*,[6] a case in which the secured creditor (in this case, a bank) was found to have assumed dominant control over an insolvent debtor. There, the bank essentially took over and then ran the debtor's business, dictating which employees were retained, choosing what debts were paid, falsely informing unsecured creditors that the debtor was still solvent, and deliberately misleading unsecured creditors to enter into new supply arrangements with the debtor. In the result, the bank's secured claims were subordinated to the claims of the bankrupt's unsecured creditors.

The U.S. doctrine continues to evolve today under a massive body of case law. For example, in the recent case of *In Re Yellowstone Mountain Club, LLC*, the doctrine was applied (in a non-insider context) where an arranging bank for a senior syndicated loan knew, or ought to have known, that its loan—which was conceived, in part, to implement a significant "dividend recap" scheme—had little likelihood of being repaid.[7] In the result, the senior secured claims of the bank syndicate were subordinated to the claims of the unsecured creditors, even though there was no evidence of control or domination by the arranging bank and no specific finding of fraud. Rather, the court concluded that the arranging bank (1) had conducted insufficient due diligence, (2) had disregarded the fact that the loan left the bankrupt too thinly capitalized, (3) had relied on inappropriate valuation methods, and (4) had arranged the loan principally to earn significant fees, while intending to hold very little of the loan post-syndication. Uniquely, and unlike most subordination cases, the impugned conduct here did not occur on the eve of the debtor's insolvency, but instead at the time of loan inception and syndication.

State of the U.S. Doctrine in Canada

In Canada, the U.S. doctrine has not yet been fully accepted as part of the Canadian legal landscape, although it is fair to say that the trend in the case law has progressed from initial statements of unrelenting resistance to cautious expressions of possible recognition. Indeed, recently, there have even been a few cases of outright application. Favourable judicial comment suggests that the U.S. doctrine may be incorporated as part of the bankruptcy court's inherent equitable jurisdiction.[8] And while it is certainly true that the *Bankruptcy and Insolvency Act* (Canada)[9] already contains various means of subordinating and invalidating certain creditor claims[10] and that various provincial statutes likewise seek to promote equitable outcomes, there is still a view that the U.S. doctrine may offer an additional tool to Canadian bankruptcy courts to better assure equitable outcomes, particularly in the toughest of cases.[11]

To date, Canada's highest court has brushed paths only briefly and obliquely with the U.S. doctrine. For example, in *CDIC v. Canadian Commercial Bank*,[12] the Supreme Court of Canada ("S.C.C.") refrained from deciding whether or not the U.S. doctrine should become part of the Canadian legal fabric. Just as importantly, however, it did not shut the door on the doctrine either. Rather, on the facts, the S.C.C. simply held that there was neither evidence of creditor misconduct nor evidence of injury to other creditors in either case, sufficient to merit a detailed consideration of the U.S. doctrine. Most recently, the S.C.C. reaffirmed this "wait-for-the-right-facts" approach in *Re Indalex Ltd.*[13] Once again, the S.C.C. left open the issue of the U.S. doctrine's acceptance in Canada, finding no evidence of creditor wrongdoing sufficient to merit an in-depth consideration of the doctrine.

As a result, numerous Canadian litigants have continued their attempts to have Canada's lower courts accept and implement the U.S. doctrine. In many of the decided cases, the applicable court found no evidence of improper or inequitable conduct, or of injury to other creditors, thereby allowing the court to sidestep detailed consideration of the U.S. doctrine.[14] Other courts of first instance have been far less charitable, suggesting that Canada's bankruptcy legislation provides a "complete code" as to the distribution of a bankrupt's estate.[15] These cases have suggested that the U.S. doctrine has absolutely no place in Canadian law and that to introduce it as part of the bankruptcy court's equitable jurisdiction would almost certainly lead to "chaos", resulting in numerous challenges to security arrangements based solely on the conduct of the secured creditor.

Still, other courts have suggested that equitable principles akin to equitable subordination may be available in cases not otherwise involving a statutory scheme of priorities such as that contained in Canada's bankruptcy legislation.[16] And at least one court has fashioned a subordination remedy based on concepts of unconscionability, without mentioning the U.S. doctrine.[17]

The situation is equally uncertain at the appellate level across the country, with the British Columbia Court of Appeal having come closest to acknowledging the court's inherent jurisdiction to adopt the U.S. doctrine.[18] Meanwhile, the Ontario Court of Appeal has largely adopted the same "wait-for-the-right-facts" approach taken by the Supreme Court of Canada.[19]

Only a handful of lower court decisions have expressly applied the U.S. doctrine.[20] For example, in *Lloyd's Non-Marine Underwriters v. J.J. Lacey Insurance Ltd.*,[21] the Newfoundland and Labrador Supreme Court subordinated the unsecured claims of an affiliate of a bankrupt company to the unsecured claims of other creditors on the basis that the affiliate had been intimately involved in a fraudulent scheme perpetrated by the bankrupt company. In this classic case of insider misconduct, the court dealt extensively with the U.S. doctrine and purported to apply it directly to the facts before it. In particular, the court ruled that the application of the U.S. doctrine was not inconsistent with the overall scheme of distribution contemplated by Canada's bankruptcy legislation, and that chaos was not likely to result from the adoption of the U.S. doctrine here in Canada.

The Future of the Doctrine in Canada

There may be many reasons for believing that the U.S. doctrine will one day fully cross the border into Canada. One reason may be the ever-increasing convergence of the U.S. and Canadian marketplaces. In particular, with the elimination of withholding taxes on most interest flows between the two countries, and the resultant convergence of the distinct financial marketplaces that once existed on either side of the border, it should not be surprising that remedies which were at one time available only to aggrieved creditors in the U.S. might now receive greater attention in Canada, especially as more and more U.S. participants (and their advisers) expand their activities here in this country.

Furthermore, and as suggested above, there is a perception among some Canadian jurists that the U.S. doctrine, if applied cautiously here, might provide Canadian bankruptcy courts with an additional tool to further promote equity, especially in those difficult cases where existing bankruptcy laws might not otherwise produce a just result. After all, the primary objective of the U.S. doctrine is to correct inequitable conduct not otherwise voided by the express provisions of existing U.S. bankruptcy laws.

Undoubtedly, legitimate concerns remain that the wholesale incorporation of the U.S. doctrine into the Canadian legal landscape will result in legal uncertainty, specifically in terms of the administration of bankrupt estates. Furthermore, acceptance may increase the overall cost of financing for participants in the Canadian marketplace. The pros and cons of adopting the U.S. doctrine have to be weighed carefully. For now, it seems that the S.C.C. may have it just about right. That is, to allow Canada's lower courts the opportunity to properly sift through the various cases of interest, all the while waiting for the right facts to come along.

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1 *In Re Autostyle Plastics, Inc.*, 269 F. 3d 726, 2001 U.S. App. LEXIS 22602 (6th Cir. 2001) [*Autostyle*]. See generally the following articles: M. Nozemack, "*Making Sense out of Bankruptcy Courts' Recharacterization of Claims: Why Not Use s. 510(c) Equitable Subordination*" (1999) 56 Wash. & Lee L. Rev. 689; Andrew DeNatale and Prudence B. Abram, "*The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*" (1985) 40 Bus. Law. 417.

2 *In the Matter of Mobil Steel Company*, 563 F. 2d 692, 1977 U.S. App. LEXIS 5956 (5th Cir. 1977).

3 See, for example, *Pepper v. Litton*, 308 U.S. 295, 1939 U.S. LEXIS 971; *In re Nassau Associates*, 169 B.R. 832 (Bankr. S.D.N.Y. 1994); *In the Matter of Clark Pipe and Supply Co. Inc.*, 893 F. 2d 693 (5th Cir. 1990), 1990 U.S. App. LEXIS 1326; and *Autostyle*, *supra* note 1.

4 See *Pepper*, *ibid*.

5 *In Re First Alliance Mortgage Co*., 298 B.R. 652, 2003 U.S. Dist. LEXIS 18448 (C.D. Calif. 2003).

6 *Bergquist v. First National Bank (In re American Lumber Co.)*, 5 B.R. 470, 1980 U.S. Dist. LEXIS 16866 (D. Minn. 1980); see also *In re Process-Manz Press, Inc*., 236 F. Supp. 233, 1964 U.S. Dist. LEXIS 7740 (E.D.N.Y. 1964).

7 *In Re Yellowstone Mountain Club, LLC*, 436 B.R. 598 (Bankr. D. Mont. 2010). The senior lenders apparently settled with unsecured creditors prior to an appeal of the case, so there was no appellate review of the lower court decision. Doubts have been expressed as to whether the lower court decision would have survived an appeal, and more generally, whether the decision would be followed by other courts. See, for example, the following articles: Jon Ann J. Brighton and Felton E. Parrish, "Yellowstone: New Standards for Lender Liability in Today's Economic Climate", ABI Journal XXVIII, no. 7 (Sept. 2009); Paul J. Ricotta, "Rekindling the War on Secured Creditors: Unsecured Creditors Score Important Early Victories", 2011 WL 586141.

8 *Laronge Realty Ltd. v. Golconda Investments Ltd.*, [1986] B.C.J. No. 848, 7 BCLR (2d) 90 (B.C.CA).

9 R.S.C. 1985, c. B-3.

10 See, for example, *ibid*., ss. 95, 96, and 136–147.

11 See discussion of legal attitudes in the following article: Thomas Telfer, "Transplanting Equitable Subordination: The New Free-Wheeling Equitable Discretion in Canadian Insolvency Law?" (2001) 38 Can. Bus. L.J. 36.

12 *CDIC v. Canadian Commercial Bank*, [1992] S.C.J. No. 96, [1992] 3 SCR 558.

13 *Re Indalex Ltd.*, [2013] S.C.J. No. 6, 2013 SCC 6.

14 See, for example, *674921 B.C. Ltd. v. Advanced Wing Technologies Corp*., [2005] B.C.J. No. 1704, 2005 BCSC 1113 (reversed on other grounds, [2006] B.C.J. No. 203, 2006 BCCA 49 (B.C.CA)); *Olympia & York Developments Ltd*. *v. Royal Trust Co*., [1993] O.J. No. 181, 8 B.L.R. (2d) 69 (Ont. Ct.–Gen. Div.) (reversed on other grounds, [1993] O.J. No. 1510, 14 OR (3d) 1 (Ont. C.A.)); *Nyugen, Re* [2013] B.C.W.L.D. 922 (B.C.S.C.); *I. Waxman & Sons Ltd., Re*, [2009] O.J. No. 4461, 62 CBR (5th) 292 (Ont. Sup. Ct.–Comm. List); *Re Pine Valley Mining Corp*., [2007] B.C.J. No. 1395, 2007 BCSC 926; *Unisource Canada Inc*. *v. Hongkong Bank of Canada*, [1998] O.J. No. 5586, 86 O.T.C. 321 (Ont. Ct.–Gen. Div.); *Lorbeth Development Corp*. v. *795243 Ontario Ltd*., 1998 CarswellOnt 3388 (Ont. Ct.–Gen. Div.); *National Bank of Canada v. Merit Energy Ltd*., [2001] A.J. No. 918, 2001 ABQB 583 (Alta. Q.B.); *New Solutions Financial Corp*. *v. 952339 Ontario Ltd*., [2007] O.J. No. 43, 29 C.B.R. (5th) 222 (Ont. Sup. Ct.–Comm. List); *Romspen Investment Corp*. *v. Edgeworth Properties*, [2012] O.J. No. 4133, 2012 ONSC 4693 (Ont. S.C.–Comm. List); *Re General Chemical Canada Ltd*., [2006] O.J. No. 3087, 22 C.B.R. (5th) 298 (Ont. Sup. Ct.–Comm. List); *Re*

Christian Brothers of Ireland in Canada, [2004] O.J. No. 359, 69 O.R. (3d) 507 (Ont. Sup. Ct.–Comm. List); and *Stone Mountain Resources Holdings Ltd. v. Stone Mountain Resources Ltd.*, 2012 CarswellAlta 2436 (Alta. Q.B.).

15 *AEVO Co. v. D & A Macleod*., [1991] O.J. No. 1354, 4 OR (3d) 368 (Ont. Ct. (Gen. Div.) in Bankr.); *Matticks v. B. & M Construction Inc. (Trustee of)*, [1992] O.J. No. 2461, 11 O.R. (3d) 156 (Ont. Ct.–Gen. Div.); *Re/Max Metro-City Realty Ltd. v. Baker (Trustee of),* [1993] O.J. No. 87, 16 C.B.R. (3d) 308 (Ont. Ct.–Gen. Div. (in Bankr.)); *Canadian Imperial Bank of Commerce* v *Sayani*, (1996) 1996 CarswellBC 2709 (B.C.S.C.).

16 *Bulut v. Brampton*, [2000] O.J. No. 1062, 48 OR (3d) 108 (Ont. CA), where the Ontario Court of Appeal applied equitable principles to subordinate a prior secured claim to a subsequent court charge.

17 *Sittuk Investments Limited v. A. Farber & Partners Inc.*, [2002] O.J. No. 3594, 61 O.R. (3d) 546 (Ont. S.C.–In Bankr.).

18 See *Laronge Realty Ltd*., *supra* note 8.

19 See *Olympia & York Developments Ltd*., [1993] O.J. No. 1510, 14 OR (3d) 1 (Ont. C.A.); *C.C. Petroleum Ltd. v. Allen,* [2003] O.J. No. 3726, 36 B.L.R. (3d) 244 (Ont. C.A.); *Re I. Waxman & Sons Ltd.*, [2010] O.J. No. 2585, 2010 ONCA 447 (Ont. C.A.).

20 See, for example, *S-Marque v. Homburg Industries Ltd*., [1998] N.S.J. No. 550 (N.S.S.C.), and *C.C. Petroleum Ltd. v. Allen*, [2002] O.J. No. 2203, 26 B.L.R. (3d) 47 (Ont. S.C.–Comm. List), although in each case, on appeal, the lower court's application of equitable subordination principles was not considered.

21 *Lloyd's Non-Marine Underwriters v. J.J. Lacey Insurance Ltd*., [2009] N.J. No. 271, 2009 NLTD 148. (Nfld. S.C.–Trial Div.).

• PREFERENTIAL PAYMENTS: COMMERCIAL IMPERATIVE OR CREDITOR PRESSURE? •

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In the recent decision of the Alberta Court of Appeal in *Orion Industries Ltd. (Trustee of) v. Neil's General Contracting Ltd.* [*Orion Industries*],[1] the court interpreted and applied the rule set out in s. 95(2) of the *Bankruptcy and Insolvency Act* [*BIA*][2] that evidence of pressure by a creditor is inadmissible to support a transaction that deals with preferential payments. The decision in *Orion Industries* suggests that a preferential payment made by a debtor that appears to have been made under pressure from the recipient creditor may nonetheless withstand challenge by a trustee in bankruptcy where there is evidence that it was made in furtherance of a reasonable business imperative.

Preferences under the *BIA*

The rules in the *BIA* concerning preferential payments that may be set aside by a court aim to prevent a debtor faced with imminent bankruptcy and a loss of control of his assets from preferring or favouring a particular creditor over others who would then be forced to wait for and accept as full payment their rateable share of any distribution in the ensuing bankruptcy.[3] The preference rules do not aim to reverse any payment that constitutes a preference in fact, but focus instead on preferential payments intended to prefer a creditor and not made for a legitimate business purpose. A payment that grants a preference to a creditor may not be voidable if it can be shown that the "dominant intent" of the debtor in making the payment was to accomplish a legitimate business objective.

For a payment to an arm's length creditor to be voidable pursuant to s. 95 of the *BIA*, three conditions precedent must be met: (1) the payment must have been made within three months of bankruptcy; (2) the debtor must have been insolvent at the time of payment; and (3) as a result of the payment, the creditor must have in fact received a preference over other creditors. If these conditions are met, the debtor will be presumed to have made the payment with a "view to prefer" the recipient creditor. This presumption is rebuttable: s. 95(2) provides that evidence the debtor made the preferential payment while under pressure from the recipient creditor is not admissible as evidence that the payment was not made with a view to prefer. As a result of the amendments to the *BIA* in 2009, s. 95(2) does not apply to preferential payments made by a debtor to non–arm's length creditors.

The Challenged Payment

In *Orion Industries*, the questioned payment was made to a creditor that, at the debtor's request, had dismantled a piece of equipment owned by the debtor and transported the disassembled equipment to a storage site owned by the creditor. More than half the debt owed to the creditor had been incurred in the dismantling and transporting of the equipment. The creditor was unwilling to release the equipment until it was paid for its services. The debtor paid the amount owed to the creditor, and the creditor released the equipment. Less than three months after the payment was made, the debtor became bankrupt.

The debtor's chief financial officer gave evidence that the debtor had made the payment in order to secure access to the equipment so that it could sell it to generate revenue. The trial judge found that the amount of income the debtor hoped to generate by liquidating the asset was considerably greater than the cost of paying the creditor. However, the chief financial officer also stated that the payment was made in the belief that the recipient creditor was in a position to cause a major customer of the debtor to cease doing business with it and effectively put the debtor out of business.

"View To Prefer" Intention Test

At trial, it was acknowledged that the payment granted a preference. The payment was therefore capable of being successfully impugned by the trustee as a voidable preference under s. 95 of the *BIA*. Pursuant to s. 95, a payment by a debtor to an arm's length creditor that grants the creditor a preference may be held to be void against the trustee if the payment is found to have been made with a view to prefer the creditor. If the payment has the effect of giving that creditor a preference, then the debtor is presumed to have made the payment with a view to prefer unless the creditor rebuts the presumption through evidence that the debtor made the payment for some other purpose.

In assessing the debtor's motivation in making the payment, the trial judge found that the debtor's dominant intent was to permit it to liquidate the equipment to recover funds for use in the business. The trial judge accepted that the debtor's decision was a reasonable response to a financial imperative and held that the evidence rebutted the presumption that the payment was made with a view to prefer. The trustee appealed on the basis that the trial judge had erred in finding that the presumption of a view to prefer had been rebutted.

The court noted that it is settled law in Canada that a payment made in the "ordinary course of business" (for example, to purchase goods or services required for on-going operations or to honour contractual obligations) will not be found to have been made with a view to prefer. The court referenced the decision of the New Brunswick Court of Appeal in *St. Anne-Nackawic Pulp Co. (Trustee of) v. Logistec Stevedoring (Atlantic) Inc*. [*St. Anne-Nackawic*] as authority for the proposition that even a preferential payment made by an insolvent debtor at a time when its financial collapse is inevitable might nonetheless be found legitimate if the payment were made with a view to generating income or liquidating assets to satisfy the insolvent debtor's creditors.[4]

Similar to the situation in *Orion Industries*, in *St. Anne-Nackawic*, the challenged payment was made by the debtor company on the eve of bankruptcy to a warehouse-operating creditor to secure release of pulp products stored in the creditor's warehouse for shipment. The New Brunswick Court of Appeal found that the debtor's dominant intent in making the payment had been to generate income from its accounts receivable, the proceeds of which would be available for the estate, and overturned the finding at trial that the payment was a voidable preference.

Following the decision in *St. Anne-Nackawic*, the court in *Orion Industries* held that an instructive analysis in determining a debtor's intention is to ask what the trustee would have done had it been in the debtor's shoes. In this case, assuming that the trustee had no better information than the debtor's chief financial officer at the time of the payment, the court found that the trustee might itself have opted to pay the creditor in order to generate income by freeing up the stored asset for a possible sale. It is noteworthy that the court held that the absence of an actual or pending sale did not render the purpose of the payment unreasonable because "the payment [may] have paved the way for the generation of income and certainly removed an obstacle to generating income".[5] The court noted that if the payment had not been made, the prospects of selling the equipment for additional liquidity would have been diminished.

Commercial Imperative or Creditor Pressure?

At trial, the trustee had not advanced any argument of pressure, instead focusing on attacking the reasonableness of paying the creditor to protect an asset that may not be capable of generating revenue for the insolvent debtor. On appeal, the trustee contended that evidence of a threat, or perceived, threat by the creditor to inform the insolvent debtor's primary customer of its payment delinquency amounted to inadmissible evidence of pressure, because this customer apparently operated under a policy of requiring its service providers to pay their suppliers in a timely manner or risk losing its business.

The court held that if there were sufficient evidence to rebut presumption of a view to prefer, then the fact that there might also have been evidence of pressure was irrelevant. The court found that the trial judge had not relied on the evidence or a perceived threat by the creditor to attempt to influence the debtor's primary customer; however, the trial judge had relied on evidence the creditor had insisted it be paid before granting the debtor access to the equipment. The trial judge had characterized that evidence not as evidence of pressure but as evidence of a normal business imperative. The Court of Appeal held that the trial judge had arrived at a reasonable characterization of the evidence and dismissed the appeal.

Final Thoughts

The decision in *Orion Industries* suggests that distinguishing inadmissible evidence of creditor pressure from admissible evidence of a commercial imperative is an exercise in characterization, and as noted by the court in this case, "characterizing such evidence is something upon which reasonable people can disagree".[6] As such, an appeal of a trial judge's characterization is an uphill battle. Further, *Orion Industries* suggests that evidence of creditor pressure, while potentially inadmissible to rebut the presumption of a view to prefer, does not undermine other evidence that supports a finding that the payment would have been made anyway on the basis of a reasonable commercial imperative.

It will be interesting to see how this issue will be treated in future cases and whether the Alberta court's distinction between evidence of pressure and evidence of a reasonable commercial imperative will be followed by courts in other jurisdictions.

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1 [2013] A.J. No. 1026, 2013 ABCA 330.
2 R.S.C. 1985, c. B-3.
3 *Re Norris*, 1996] A.J. No. 975, [1997] 2 W.W.R. 281, para. 16 (Alta. C.A.).
4 [2005] N.B.J. No. 204, 2005 NBCA 55.
5 *Supra* note 1, para. 25.
6 *Supra* note 1, para. 34.

• THE TEST FOR GRANTING LEAVE TO SUE A COURT-APPOINTED RECEIVER •

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In the December 2013 issue of *National Insolvency Review*, James Desjardins examined disclaimers that receivers and other court-appointed officers commonly include in reports they file with the court (and the growing trend among judges in disallowing disclaimers that are too broad).[1] Such disclaimers help to shield receivers from liability to third parties who may rely on the representations made in the reports.

This article looks at another protection afforded to receivers, not in respect of representations they make but in respect of their conduct as custodians of a company in receivership. A receiver may often face lawsuits of varying degrees of merit from creditors, shareholders, and even former officers or directors who may have their own ideas on how the company's assets should be managed and distributed. Section 215 of the *Bankruptcy and Insolvency Act*,[2] however, provides that no proceeding may be commenced against an official receiver or interim receiver without first obtaining leave of the court.

Canadian courts have recognized two different tests for granting leave to commence an action against a receiver: the "frivolous or vexatious" test and the more stringent "strong *prima facie* case" test. The question of which test applies depends on whether or not the receiver's impugned activities, which are the subject of the proposed action, have already been approved by the court.

The "Frivolous or Vexatious" Test

If the receiver's activities have not yet received court approval, then in order to be granted leave, the plaintiff need only establish that the proposed action is neither frivolous nor vexatious. The plaintiff can do so by providing sufficient evidence that (1) "there is a factual basis for the proposed claim", and (2) "the proposed claim discloses a cause of action".[3]

In *GMAC Commercial Credit Corporation – Canada v. T.C.T. Logistics Inc.*,[4] the Supreme Court of Canada endorsed the following principles, which were first enunciated by the Ontario Court of Appeal in *Mancini (Trustee of) v. Falconi*:[5]

1. Leave to sue a trustee [or a receiver] should not be granted if the action is frivolous or vexatious. Manifestly unmeritorious claims should not be permitted to proceed.
2. An action should not be allowed to proceed if the evidence filed in support of the motion, including the intended action as pleaded in draft form, does not disclose a cause of action against the [receiver]. The evidence typically will be presented by way of affidavit and must supply facts to support the claim sought to be asserted.
3. The court is not required to make a final assessment of the merits of the claim before granting leave.[6]

The Supreme Court of Canada also noted the following:

> [T]he threshold for granting leave to commence an action against a receiver or trustee is not a high one. [...] The gatekeeping purpose of the leave requirement […] is to prevent the trustee or receiver "from having to respond to actions which are frivolous or vexatious or from claims which do not disclose a cause of action" so that the bankruptcy process is not made unworkable. On the other hand, it ensures that legitimate claims can be advanced.[7]

Given the low bar that must be met, a plaintiff in these circumstances will generally be granted leave to sue the receiver, even if the proposed action has questionable merit, as long as the action does not go so far as being frivolous or vexatious.

The "Strong *Prima Facie* Case" Test

In situations where a plaintiff seeks to sue a receiver over activities that the court has already approved, the court may apply a more stringent test for leave: the "strong *prima facie* case" test. This test requires the plaintiff to establish through evidence that its proposed action has a reasonable chance of success at trial. It requires the court to give a preliminary assessment of the case's overall merit.

Justice Blair, then at the Ontario Court (General Division), explained the necessity of a stricter test in *Bank of America Canada v. Willann Investments Ltd.* [*Willann*]:

> In my opinion the "normal" test [*i.e.*, the "frivolous or vexatious" test] referred to above sets a threshold which is too low in cases where the activities of the Receiver, including the conduct sought to be impugned by the creditor seeking leave to proceed, have already been approved by the Court. In such circumstances, I prefer the analogy to the test for the granting of an interlocutory injunction […] I would endorse the more stringent "strong *prima facie* case" test.
>
> Were it otherwise there would be little point in a receiver or receiver/manager seeking an Order approving its conduct and activities in the exercise of its duties as an officer of the Court. The very purpose of the granting of such an Order is to afford the receiver some measure of judicial protection. To say that that shield may be readily pierced unless the receiver can show that "it is perfectly clear" there is no foundation to the proposed claim, or that it is frivolous or vexatious, is to render such protection virtually meaningless in situations where the approved conduct and the conduct subject to the proposed attack are in substance the same.[8]

However, since *Willann*, the courts have shown an aversion to the "strong *prima facie* case" test and have narrowed its application. It now applies only if both (1) the receiver's impugned activities have received previous approval by the court, *and* (2) the plaintiff raised or had the opportunity to raise the same issues in the earlier court proceedings as he or she now seeks to do in his or her proposed lawsuit.[9] If these conditions are not met, the court will apply the "frivolous or vexatious" test.

For example, in *Gallo v. Beber*,[10] the court had issued an order discharging the receiver and approving its activities before the plaintiff brought its leave application. Nonetheless, the court applied the lower "frivolous or vexatious" test and granted leave to the plaintiff to sue the receiver, because the plaintiff did not have notice of the earlier discharge application and therefore could not have brought the issues now raised in its proposed action to the attention of the judge at the discharge hearing.

Applying the Same Test for Leave to Each Proposed Cause of Action

Once the appropriate test for leave has been determined, the court will apply it to each cause of action that the plaintiff seeks to assert, and strike those that fail to meet the test. This prevents a plaintiff from moving forward with a claim that contains a host of meritless causes of action merely because the plaintiff has managed to plead one that meets the test for leave. For instance, in *Mortgage Insurance Co. of Canada v. Innisfil*,[11] two individual plaintiffs sought leave with respect to five causes of action against a receiver-manager. The court applied the "strong *prima facie* case" test to each cause of action and granted leave on only some of those claims, barring the rest from proceeding.

The Receiver's Appointment and Discharge Orders

It is a common practice for the receiver to obtain limited liability protections by way of court order when being appointed as receiver, seeking court approval of its activities, or being discharged of its responsibilities.

For example, the Ontario Superior Court of Justice's standard form for a receivership order suggests inclusion of the following:

> 17. THIS COURT ORDERS that the Receiver shall incur no liability or obligation as a result of its appointment or the carrying out of the provisions of this Order, save and except for any gross negligence or wilful misconduct on its part. […] Nothing in this Order shall derogate from the protections afforded the Receiver by [the *Bankruptcy and Insolvency Act*] or by any other applicable legislation.[12]

The standard form for a discharge order, meanwhile, suggests inclusion of the following:

> 5. THIS COURT ORDERS AND DECLARES that [the Receiver] is hereby released and discharged from any and all liability that [the Receiver] now has or may hereafter have by reason of, or in any way arising out of, the acts or omissions of [the Receiver] while acting in its capacity as Receiver herein, save and except for any gross negligence or wilful misconduct on the Receiver's part. Without limiting the generality of the foregoing, [the Receiver] is hereby forever released and discharged from any and all liability relating to matters that were raised, or which could have been raised, in the within receivership proceedings, save and except for any gross negligence or wilful misconduct on the Receiver's part.[13]

Incorporating such language in a court order adds another layer of protection for the receiver and helps to narrow the receiver's exposure to claims, in recognition that the receiver is often not a legitimate target for the competing creditors, save for clear acts of misconduct.[14]

Comment

In drafting orders for the court's review and approval, receivers should include language that expressly limits their own liability as much as the court will allow. Further, given the significantly higher threshold for leave that a plaintiff may have to meet if the activities that are the subject of its claim have already been approved by the court, receivers would be wise to be as broad, inclusive, and timely as possible when reporting to or seeking approval of the court in respect of its activities. A receiver should also ensure that all potentially affected parties receive notice of its court appearances, in order to preclude potential plaintiffs from subsequently suing the receiver personally on issues that they could have raised at an earlier proceeding. Meanwhile, plaintiffs hoping to assert an action against a receiver personally should act as swiftly as possible to issue their leave application before the receiver has had opportunity to obtain court approval of its activities.

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[1] James Desjardins, "Broad Disclaimers in Reports to Court No Longer Accepted", Nat. Insol. Rev. 30, No. 6 (2013): 69.

[2] R.S.C. 1985, c. B-3.

[3] *Mancini (Trustee of) v. Falconi*, [1993] O.J. No. 146, 61 O.A.C. 332 [*Mancini*] (Ont. C.A.). See also *Marsh Engineering Limited v. Deloitte & Touche Inc.*, [2008] O.J. No. 5277, 49 C.B.R. (5th) 286, para. 32 (Ont. Sup. Ct.).

[4] *GMAC Commercial Credit Corporation – Canada v. T.C.T. Logistics Inc.*, [2006] S.C.J. No. 36, 2006 SCC 35 [*GMAC Commercial Credit Corporation*].

[5] *Mancini*, *supra* note 3.

[6] *Supra* note 4, para. 57.

[7] *GMAC Commercial Credit Corporation*, *supra* note 4 at paras. 55, 58, 59 (citations omitted).

[8] *Bank of America Canada v. Willann Investments Ltd.*, [1993] O.J. No. 3039, 23 C.B.R. (3d) 98 (Ont. Ct.–Gen. Div.), paras. 9–10.

[9] *80 Aberdeen Street Ltd. v. Surgeson Carson Associates Inc.*, [2008] O.J. No. 269, 40 C.B.R. (5th) 109, para. 49 (Ont. Sup. Ct.).

[10] *Gallo v. Beber*, [1998] O.J. No. 5357, 116 O.A.C. 340 (Ont. C.A.).

[11] *Mortgage Insurance Co. of Canada v. Innisfil*, [1996] O.J. No. 1760, 3 O.T.C. 44 (Ont. Ct.–Gen. Div.).

[12] Ontario Superior Court of Justice, Practice Directions and Policies (Toronto), Standard Form Template Receivership Order, para. 17, <http://www.ontariocourts.ca/scj/practice/practice-directions/toronto/standard-form/#Receiver_or_Interim_Receiver>.

[13] Ontario Superior Court of Justice, Practice Directions and Policies (Toronto), Standard Form Template Discharge Order, <http://www.ontariocourts.ca/scj/practice/practice-directions/toronto>.

[14] *Ibid*.