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• SUPREME COURT OF CANADA SIDES WITH SECURED CREDITOR IN FRAUD CASE •

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In a contest between two creditors over the proceeds of shares credited to an investment account which were traceable to fraudulently obtained funds, the Supreme Court of Canada held in favour of Bank of Montreal ("BMO"), a secured creditor. While the secured creditor came out ahead in this case, the timing of how the case unfolded was a significant contributing factor to that success and lenders must remain on guard for fraudsters.

In *i Trade Finance Inc. v. Bank of Montreal*,[1] the Court had to determine whether shares purchased through a pool of funds advanced under a fraudulent representation could be claimed by i Trade Finance Inc. ("i Trade"), which had lent money to the defrauding party (the "Fraudster") or to BMO, who accepted a pledge of the shares from the Fraudster as security for an advance under a MasterCard account. The Court characterized i Trade's interest as an equitable interest in the shares which was defeated by the *Personal Property Security Act* (Ontario) [the *PPSA*] R.S.O. 1990, c. P.10, security interest held by BMO. The decision hinges on the timing of

• DEMANDING REPAYMENT OF LOANS AND REASONABLE NOTICE — BACK TO THE FUTURE •

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Introduction

In the 1980s, the courts imposed a legal obligation on business lenders to provide a borrower with reasonable notice before enforcing security. The consequences to the lender for acting precipitously and failing to give the borrower reasonable prior notice were serious, with some damage awards being many times larger than the outstanding loans. Since the introduction in 1992 of s. 244 of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 [*BIA*], requiring a secured lender to give ten days prior written notice of its intention to enforce security in certain circumstances, the practical significance of this principle has faded. However, the recent decision of the Ontario Superior Court of Justice in *Bank of Montreal v. Carnival National Leasing Ltd.*, [2011] O.J. No. 671, demonstrates that the principle of reasonable notice can still be relevant. Fortunately, the case provides some comfort to lenders in respect of the application of the principle by the courts.

Key Take-Aways

Key take-aways from the *Carnival Leasing* case are:

- No breach of the terms of the loan is required before a lender can call a demand loan.
- In most cases, reasonable notice as determined under common law will typically be no more than a few days.
- Lenders should ensure their security agreements include the debtor's consent and agreement to the secured creditor appointing a receiver or bringing a motion to the court to request the appointment of a receiver.
- Establishing a course of conduct on the part of a lender that amounts to a waiver of certain of its legal rights will require evidence beyond just that the specific term of the loan was not strictly enforced. The debtor will need to provide evidence that the secured lender intended to waive compliance with the subject requirements.

Facts of Case

The relevant reported facts in *Carnival Leasing* are fairly straightforward. BMO extended an automobile lease financing facility and an overdraft operating line of credit to Carnival. Both facilities were made on a demand basis and could be cancelled at any time by BMO in its sole discretion.

The lease facility was available to finance the cost of a vehicle that was subject to an approved lease. The lease facility contained a requirement that advances to finance used vehicles under it could not exceed 30 per cent of the total advances. BMO's agreement with Carnival included a covenant that required Carnival to provide an annual detailed analysis of the entire lease portfolio, including a breakdown of the lease concentrations. No evidence was provided that Carnival ever complied with this requirement. It turned out, however, that for some time Carnival had significantly exceeded the permitted concentration level of used vehicles in its lease portfolio. The Bank's internal annual reviews had

stated that the concentration of used vehicles was below the 30 per cent limit.

When BMO's account management team learned that the concentration of used cars exceeded the 30 per cent threshold, Carnival was advised in writing that the bank would not provide any further financing under the leasing facility until BMO's financial advisor completed a review, that it would no longer allow any overdraft on Carnival's operating line and that the bank reserved its rights to demand repayment at any time.

Following the review by the financial advisor, BMO demanded payment and subsequently applied to the Court for the appointment of a receiver. The borrower opposed.

Reasonable Notice

The Supreme Court of Canada established in the early 1980s the general principle that a lender must provide a business borrower with "reasonable notice" before appointing a receiver to recover a secured demand loan. What is reasonable depends upon the facts of each case.

The decision of Justice Newbould in *Carnival Leasing* re-affirms the guidance provided by the leading cases decided in the late 80s and early 90s that reasonable notice is typically measured in days and not weeks. No breach of the terms of the loan is required before a lender can call a demand loan. The judge stated that generally reasonable time will be of a short duration, not more than a few days and not encompassing anything approaching 30 days.

No mention was made in the decision regarding the ten-day notice required to be given to a debtor by its secured creditor pursuant to s. 244 of the *BIA*. In practice, the secured lender that intends to enforce it security typically issues the s. 244 notice along with its demand letter with the view that the ten-day period constitutes sufficient reasonable notice. However, there have been exceptional cases where reasonable notice was held to be longer than ten days.

There were also cases that applied the reasonable notice principle not only to the appointment of a receiver, but also to the termination of availability under credit facilities.

Course of Conduct and Waiver

Carnival argued that BMO actually knew or had constructive knowledge of the fact that the concentration levels of the used cars in its portfolio exceeded the 30 per cent limit and by continuing to advance in the face of the excess concentration levels, BMO should be taken to have waived compliance through its course of conduct. The upshot of this argument was intended to be that the demand made by BMO was improper. The evidence presented in the case revealed that Carnival had provided BMO's automotive centre with copies of the individual leases and bills of sale which showed the model year of the car to be financed and the information was in BMO's automotive centre computer records. The evidence of the bank, which was accepted by the judge, was that BMO's account management team was not aware of that information.

The judge rejected Carnival's argument that the bank's demand was improper for a number of reasons. The judge did not find that the account management team had actual or constructive knowledge of the used car concentration exceeding 30 per cent (even if it could be construed as being BMO's fault, which the judge did not think was the case). The judge held that in any event the loans were payable on demand and the bank did not have to establish a default in order to demand payment.