

# CONSTRUCTION TRUSTS CAN APPLY TO FUNDS RECEIVED BY CCAA MONITOR: THE COURT OF APPEAL'S DECISION IN **URBANCORP**

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There is good news from the Ontario Court of Appeal for contractors dealing with insolvent owners. In a recent decision in *Urbancorp Cumberland 2 GP Inc. (Re) ("Urbancorp")*,<sup>[1]</sup> the Court of Appeal held that statutory trusts can arise under the *Construction Act*<sup>[2]</sup> over sale proceeds received by a court officer in a court-supervised sale process under the *Companies' Creditors Arrangement Act* ("CCAA").<sup>[3]</sup> The decision also limited the application of the Court of Appeal's earlier decision in *Re Veltri Metal Products Co. ("Veltri")*.<sup>[4]</sup> *Veltri* does not stand for a blanket rejection of construction trusts over the proceeds of a court-supervised sale in insolvency proceedings.

Contractors now have further assurance that they can rely on construction trusts even where owners are in financial distress. Lenders and other creditors in the construction industry should take note of the impact that construction trusts may have on their recoveries within Canadian insolvency proceedings.

Background to the **Urbancorp** Decision

A residential condominium developer, the Cumberland Group ("Cumberland"), obtained protection from its creditors under the CCAA. As part of the CCAA proceeding, a court-appointed monitor sold condominium units that Cumberland owned. The net proceeds from the sales totaled over \$4.2 million.

Several of Cumberland's contractors on the project had supplied work and materials for the units that were sold. One of the Cumberland entities, Urbancorp, owed these contractors a total of nearly \$4 million. The contractors claimed that a trust in their favour had arisen over the condominium sale proceeds pursuant to section 9(1) of the *Construction Act*. That section provides that when an owner sells its interest in a property that contractors have improved through labour or materials, a trust arises in favour of those contractors in an amount equal to the sale proceeds minus certain deductions. Where a debtor holds funds that are impressed with a trust, the funds do not form part of the debtor's estate. They are consequently not subject to the priority and distribution rules in insolvency legislation, which typically limit recoveries for contractors and other unsecured creditors.

The motion judge in *Urbancorp* initially denied the contractors' trust claim. He held that an asset sale by the monitor in a CCAA proceeding cannot give rise to a construction trust over the sale proceeds. He relied on the *Veltri* decision for this proposition. The contractors appealed to the Ontario Court of Appeal.

### **The Ontario Court of Appeal's Decision**

The Court of Appeal overturned the motion judge's decision. It held that a section 9 construction trust can arise in respect of sale proceeds in a CCAA proceedings. In doing so, the Court addressed two legal issues.

#### ***(i) Is Section 9 of the Construction Act Inoperative in Bankruptcy Proceedings?***

First, the Court of Appeal considered whether section 9 is ineffective in CCAA proceedings based on constitutional principles. The federal government has the exclusive power to make laws governing bankruptcy and insolvency.<sup>[5]</sup> The provinces may not make laws that (i) in substance regulate bankruptcy and insolvency; or (ii) are inconsistent with federal bankruptcy and insolvency laws. To the extent that any portion of the Ontario *Construction Act* is inconsistent with the federal *Bankruptcy and Insolvency Act* ("BIA"), the constitutional doctrine of federal paramountcy renders the provincial statute inoperative to the extent of the inconsistency.

The Court of Appeal recently considered the issue of paramountcy in connection with statutory trusts under the *Construction Act* in insolvency proceedings. In *The Guarantee Company of North America v. Royal Bank of Canada* ("*Guarantee*"),<sup>[6]</sup> it first examined the substance of section 8 trusts under the *Construction Act* (regarding amounts owing to, or received by, contractors and subcontractors). The Court held that the purpose of a section 8 trust is to protect construction industry participants from the unjust enrichment of parties higher up the construction pyramid. Accordingly, it was not in substance an improper attempt to regulate bankruptcy.

Next, the Court of Appeal in *Guarantee* considered whether the statutory trust imposed by section 8 is inconsistent with the *BIA* because the trust requirements differed under the two statutes. Section 67(1)(a) of the *BIA* requires that trust property satisfy the common law definition of a trust.<sup>[7]</sup> At common law, a trust can only arise if the 'three certainties' are met: there must be certainty of intention (to create the trust), certainty of object, and certainty of subject matter. There has been some debate about whether statutory trusts can satisfy the three certainties, specifically relating to certainty of intention.<sup>[8]</sup> In *Guarantee*, the Court of Appeal concluded that statutory trusts can create the necessary certainty of intention under the common law. Applying this finding, the Court of Appeal held that section 9 of the *Construction Act* satisfied the three certainties of a trust. As such, there was no constitutional basis to hold the section 9 trust to be inoperative.

#### ***(ii) The Veltri Decision Did Not Invalidate Section 9 Construction Trusts***

The Court of Appeal then considered the impact of the CCAA context on the trust claim. At issue in *Urbancorp* was whether a trust could arise given that the sale proceeds were received by the CCAA monitor rather than by the debtor. The text of section 9(1) of the *Construction Act* requires that trust property be “received by the owner as a result of a sale”. The motion judge interpreted *Veltri* to mean that the requirement is not met where the funds are paid to a CCAA monitor rather than to the owner. Accordingly, he held that he was bound by *Veltri* to reject the trust claim.<sup>[9]</sup>

Following a close examination of the facts in *Veltri*, the Court of Appeal held that it had a narrower application than the motion judge allowed. The absence of a trust in *Veltri* was not because the court officer in that proceeding held sale proceeds in trust for creditors (as opposed to owners). Rather, there was no trust in *Veltri* because there were no sale proceeds over which a trust could be asserted. This was a consequence of specific circumstances affecting the trust claim in that case. The circumstances in *Urbancorp* were distinguishable as there were net sale proceeds from the condominium unit sale. The Court of Appeal concluded that *Veltri* does not stand for the proposition that construction trusts cannot arise through sales by a court officer.

## **Implications for the Construction Industry**

### *For Creditors*

The *Urbancorp* decision has significant implications for stakeholders in the construction industry. Successful trust claims will diminish the size of debtors’ estates that can be realized for secured creditors. Statutory trust claims are potentially quite substantial where large and complex construction projects are involved. Secured creditors are not protected from the intrusion of trust claims on their collateral simply because a court officer is administering the owner’s property. They should be aware at the outset of their involvement in a construction project of the potential for such claims to diminish their recoveries in an insolvency situation. Lenders should keep this collateral risk top of mind, both when they are conducting diligence and negotiating reporting obligations in their loan documents and as owners make draws on loan facilities into the course of a construction project.

### *For Contractors*

The *Urbancorp* decision gives assurance to contractors and other beneficiaries of construction trusts who are concerned with owner insolvency. A contractor’s ability to assess an owner’s financial health is often quite limited. Statutory trusts reduce some of the risk of performing construction work for an owner whose financial status is uncertain.

However, the statutory trust protections are not unlimited. The trust still only arises over net sale proceeds. As such, certain deductions could erode the monies available for a potential trust. Contractors should continue to

use all the tools at their disposal, including liens, prompt payment rules, and section 39 information requests, among other things, to protect themselves from the consequences of owner insolvency.

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[1] 2020 ONCA 197.[ps2id id='1' target=""]

[2] 1990 c C.30.[ps2id id='2' target=""]

[3] RSC 1985, c C-36.[ps2id id='3' target=""]

[4] [2005] O.J. No. 3217 (ONCA).[ps2id id='4' target=""]

[5] *Constitution Act*, 1867, section 91 (21).[ps2id id='5' target=""]

[6] 2019 ONCA 9.[ps2id id='6' target=""] [ps2id id='7' target=""]

[8] Sam Babe, "Deemed Provincial Trusts 30 Years After *British Columbia v Henfrey Samson Belair Ltd.*" (2019) *Ann Rev Insolv* 23; Aline Grenon, "Common Law and Statutory Trusts: In Search of Missing Links" (1995) 15:2 *ETPJ* 109 at 116-117.[ps2id id='8' target=""]

[9] *Urbancorp* at para 23.[ps2id id='9' target=""]

### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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