

# WHERE THE RESTRUCTURING MEETS THE ROAD: THE INTERSECTION BETWEEN INSOLVENCY PROCEEDINGS AND CONSTRUCTION LAW

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The construction industry is one of many that may be strained as a result of the current COVID-19 global pandemic. And the insolvency of any party in the construction pyramid often impacts many of the other parties in the same structure. Consequently, prudence in the construction business calls for general awareness of key issues at the intersection of construction and insolvency law. This bulletin considers three of those key issues: (1) the “stay of proceedings;” (2) the operation of the *Construction Act*<sup>[1]</sup> trust provisions in an insolvency context; and (3) the treatment of suppliers critical to the restructuring of a construction business.

## Stay of Proceedings

A key feature of any insolvency proceeding is a “stay of proceedings.” A stay operates to prevent parties from commencing a new legal proceeding against a debtor that has filed for protection under one of Canada’s insolvency and restructuring statutes. For example, a stay prevents trade creditors from commencing construction lien actions against a contractor that has filed for bankruptcy under the *Bankruptcy and Insolvency Act* (“**BIA**”).<sup>[2]</sup>

The scope of a stay is slightly different in a proceeding under the *Companies’ Creditors Arrangement Act* (“**CCAA**”).<sup>[3]</sup> The usual order obtained at the start of a CCAA proceeding contains a carve-out from the stay for the registration of claims for lien. Where the CCAA debtor is a general contractor, however, the registration of claims for lien can paralyze the business, because the registration of a lien is often grounds for an owner to freeze any further progress payments.

Thus, in a 2013 CCAA case involving a general contractor, the initial order omitted the usual carve-out for registration of lien claims, because the exercise of lien rights would have stopped the flow of payments on various projects and limited the debtor’s ability to operate as a going concern.<sup>[4]</sup> The broad stay was highly prejudicial to potential lien claimants. As a compromise, the court issued a “lien regularization order,” which created an alternative lien-claim regime to the statutory lien framework, but had no impact on the debtor’s ability to demand progress payments. Lien regularization orders are now routinely issued in CCAA proceedings

involving contractors.

In addition to preventing parties from commencing new legal proceedings against a debtor, a stay prevents parties from terminating a contract with the debtor by reason of the bankruptcy,<sup>[5]</sup> and pauses any legal proceedings already underway. Though a party prejudiced by the stay may ask the court to have it set aside,<sup>[6]</sup> such orders are rare.

### **Construction Act Trust Claims**

Trust claims receive unique treatment in the context of insolvency proceedings. Money held by the debtor in trust for another party does not form part of the assets of the estate, and is therefore not available for distribution to creditors.<sup>[7]</sup>

The *Construction Act* provides for several different trusts.

Under section 8 of the *Construction Act*, for example, amounts owing to a contractor or subcontractor constitute trust funds for the benefit of the contractor or subcontractor with receivables outstanding.<sup>[8]</sup> The validity of that statutory trust within an insolvency proceeding was recently affirmed in *The Guarantee Company of North America v. Royal Bank of Canada*.<sup>[9]</sup> In that case, the debtor operated a paving business and went bankrupt before collecting a receivable owed from a municipality for completed work. The Receiver appointed over the business and affairs of the paving company was ultimately paid the amounts owing from the municipality, and further to a court order deposited the funds into an account commingled with funds received in respect of other projects.

In a priority dispute over the deposited funds, one creditor argued that no valid trust had been established over the deposits, because they had been commingled with money paid to satisfy other receivables. The Ontario Court of Appeal disagreed, holding that the commingling of funds from various projects did not preclude the creation of a trust because the funds remained identifiable and traceable. Accordingly, the funds from the municipality comprised of a trust for the benefit of unpaid suppliers and did not form part of the debtor's assets.

And just earlier this year, the Ontario Court of Appeal released its reasons in *Urbancorp Cumberland 2 GP Inc. (Re)*,<sup>[10]</sup> holding that a trust provided for in section 9 of the *Construction Act* also survives an insolvency filing. That section serves to create a trust for the benefit of an unpaid contractor in the proceeds of sale of a premises the contractor improved. In *Urbancorp*, the trust was upheld even though the sale proceeds had been paid out to a court-appointed Monitor overseeing Urbancorp's CCAA proceedings, as opposed to the owner of the property expressly identified as the trustee of the section 9 trust in the *Construction Act*.

Accordingly, the trust provisions in the *Construction Act* constitute a powerful tool available to construction

industry stakeholders to recoup funds which, in other industries, would be a total write-off for creditors.

### **Supplying an Insolvent Contractor**

A supplier already out of pocket for supply to a contractor with the benefit of protection from its creditors would rightly be wary of supplying anything further on usual credit terms. While the “stay” discussed above does prevent a supplier from terminating its supply contracts by reason only of an insolvency filing, both the *BIA* and *CCAA* insulate a supplier from any obligation to extend additional credit to a debtor with the benefit of statutory protection from its creditors.<sup>[1]</sup> But where the maintenance of supply is critical to a restructuring effort, and the debtor’s cash flow is such that cash-on-delivery is not practical, a court may make an order declaring a person to be a “critical supplier” to the debtor.<sup>[2]</sup> A critical supplier may be ordered to supply goods or services that are critical to a company’s continued operations, although such a supplier is entitled to security for the additional credit – which may rank in priority to other secured creditors.

The right to avoid the extension of further credit, and the protection for critical suppliers of a first-in-priority charge on the assets of a debtor where c.o.d. isn’t available offer suppliers to construction projects protection from further exposure to insolvent contractors. Suppliers are well-served by leveraging these protections where a customer’s insolvency is brought to their attention.

### **Takeaway**

The fallout of a stay of proceedings against an insolvent debtor that is part of a construction pyramid, the trusts provided for in the *Construction Act*, and the rights afforded to suppliers of insolvent businesses all feature prominently in construction-related insolvency proceedings under the *BIA* and *CCAA*. As insolvency proceedings are commonly fast-moving, industry stakeholders aware of these concepts are well-positioned to pursue legal advice at an early stage where their rights can best be protected.

by Jeffrey Levine and Nicole Rozario

[1] *Construction Act*, R.S.O. 1990, Ch C.30 (“**Construction Act**”)

[2] *Bankruptcy and Insolvency Act*, R.S.C., 1985, c. B-3 (“**BIA**”), s. 69(1).

[3] *Companies’ Creditors Arrangement Act*, R.S.C., 1985, c. C-36. (“**CCAA**”)

[4] See *Comstock Canada Ltd. (Re)*, 2013 ONSC 6043.

[5] *BIA*, s. 84.2(1).

[6] For example, under *BIA*, s. 69.4(1).

[7] *BIA*, s.67(1)(a).

[8] *Construction Act*, s.8.

[9] 2019 ONCA 9.

[10] 2020 ONCA 197.

[11] BIA, s. 65.1(4); CCAA, s.11.01.

[12] CCAA, s.11.4(1).

### **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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