Supreme Court of Canada clarifies when arbitration may be used in an insolvency situation

December 16, 2022

Case commented: Peace River Hydro Partners v. Petrowest Corp., 2022 SCC 41.

Commercial parties enter into arbitration agreements for various reasons, often among them efficiency and confidentiality. When one party to an arbitration agreement becomes insolvent, however, the other party may lose its contractual right to arbitrate disputes, resulting in public court proceedings. This is the key takeaway from the Supreme Court of Canada's (SCC) latest analysis of arbitration in an insolvency context in Peace River Hydro Partners v. Petrowest Corp., 2022 SCC 41 (*Petrowest*).

Case facts

Peace River Hydro Partners (Peace River) is a partnership formed to build a hydroelectric dam in northeastern British Columbia. Petrowest Corporation (Petrowest) is a construction company and a member of the Peace River partnership. Work on the dam was subcontracted to Petrowest and its affiliates. Both the main partnership and guarantee agreements between the partners, as well as purchase orders and subcontracts to Petrowest and its affiliates, contained arbitration clauses requiring all disputes arising under the various agreements to be resolved through arbitration.

Two years into the partnership, Petrowest found itself in financial difficulties and was petitioned into receivership. The receiver sued Peace River in the B.C. Supreme Court for sums allegedly owed to Petrowest and its affiliates under the main agreements, and the purchase orders and subcontracts. Peace River applied to the court to stay the court proceedings in favour of arbitration.

Issues relating to arbitration and insolvency

Section 15(1) of B.C.'s *Arbitration Act* provides that if a party to an arbitration agreement commences a lawsuit in a court, the other party may apply to the court for a stay in favour of arbitration. Section 15(2) provides that a court "must" stay the lawsuit unless the arbitration agreement is "void, inoperative or incapable of being performed."

Accordingly, the crux of the dispute before the courts was whether the court-appointed receiver under the *Bankruptcy and Insolvency Act* (BIA) was a "party" to the arbitration agreements, and whether the arbitration agreements were "inoperative or incapable of being performed" due to the receivership and the operation of insolvency law.

Below courts ' decisions

The chambers judge refused to stay the lawsuit. She found that although the receiver was a "party" to the arbitration agreement, and the arbitration agreement was not void, inoperative or incapable of performance, the court had a residual discretion to refuse a stay, which she exercised. This arose from the court's inherent jurisdiction and extended to situations where the *Bankruptcy and Insolvency Act* was engaged. On this point, the chambers judge found that the requirement for multiple arbitrations under the various agreements would lead to significant cost and delay, while a single court proceeding would be faster and less expensive.

The Court of Appeal also refused the stay, but on a different basis than the chambers judge. It held that the receiver could adopt the agreements for the purposes of pursuing claims, while disclaiming the arbitration clause, relying on the doctrine of separability of the arbitration clause. Accordingly, the receiver was not a "party" to the arbitration clause.

Decision of the Supreme Court of Canada

Like the courts below, the SCC dismissed the appeal and refused to stay the litigation. The SCC's reasons differed from both the Court of Appeal and the chambers judge. Justice Côté, writing for the majority, found that the receiver had become a party to the arbitration clause and that there was no residual discretion for the court in deciding whether to grant a stay under the *Arbitration Act*.

The SCC held that an insolvency situation, on its own, is not a sufficient basis to render an arbitration agreement inoperative. However, in this case, the chaotic nature of the multiple arbitration proceedings, in the face of the simplicity and efficiency of the single lawsuit, exceptionally rendered the arbitration agreements inoperative. In arriving at this conclusion, the SCC set out a number of factors to be applied by courts facing requests to stay proceedings in favor of arbitration in situations when one of the parties is insolvent.

The majority 's decision

First, the receiver became a party to the arbitration clauses by operation of ordinary contractual principles. In Justice Côté's view, it is fundamental to the law of contracts that a party cannot take the benefit of a contract while avoiding its burdens. In this case, the receiver's right to sue arose only through the contractual rights of Petrowest and the Petrowest affiliates. It could not therefore avoid the arbitration clauses in those agreements, but became a party to them in a similar way to an assignee.

Second, the mandatory language of the B.C. *Arbitration Act* was construed narrowly. Unless an arbitration agreement is "void, inoperative or incapable of being performed" the court cannot, in general, refuse to stay. However, in the majority's view, the BIAdoes

grant courts jurisdiction to find an arbitration agreement "inoperative" where parallel insolvency proceedings are underway.

Third, where the arbitration clause could compromise the orderly and efficient resolution of a receivership, it may become "inoperative" within the meaning of the Model Law, the B.C. *Arbitration Act* and other similar statutes across Canada. This is, according to the majority, a fact-driven exercise, which should be based on five factors:

i. the effect of arbitration on the integrity of the insolvency proceedings;
ii. the relative prejudice to the parties from the referral of the dispute to arbitration;
iii. the urgency of resolving the dispute;
iv. the applicability of a stay of proceedings under bankruptcy or insolvency law; and
v. any other factor the court considers material in the circumstances.

Fourth, those using arbitration should pay close attention to the reasoning of the SCC on three core elements of arbitration law:

- The burden of proof and the "two-step framework" for motions to stay proceedings in favour of arbitration (paras. 76-90);
- The competence-competence principle: the SCC reaffirmed the importance of the competence-competence principle, according to which a challenge to an arbitrator's jurisdiction should generally be decided at first instance by the arbitrator (paras. 38-43); and
- The separability doctrine (paras. 166-168): the SCC roundly rejected the B.C. Court of Appeal's invocation of the separability doctrine. Justice Côté recalled that the purpose of separability is to "safeguard arbitration agreements, not imperil them."In general, separability only applies where there is a challenge to the validity of the main contract.

The minority concurred on the result, but would have based the refusal of the stay on the terms of the receivership order. In the minority's view, the combined effect of the receivership order was to authorize the receiver to disclaim any contracts, on the one hand, and to sue or bring proceedings, on the other. This meant that the receiver could disclaim the arbitration agreement but sue on the underlying contract.

Takeaways

The SCC's finding that the receiver, by suing under the debtor's agreements, thereby becomes a party to the arbitration clauses and its rejection of the proposed extension of the separability doctrine, proposed by the B.C. Court of Appeal, provides clarity to the standing of receivers under arbitration agreements.

However, the "fact-driven" interpretation of when insolvency proceedings may render an arbitration agreement "inoperative" is less clear, due to the case-specific application of the five factors set out by the majority.

These factors will provide some guidance to courts in future cases where there are insolvency proceedings and arbitration agreements. Where a receiver initiates proceedings under a single agreement and a single arbitration clause, arbitration will likely be the most efficient proceeding. However, most commercial transactions involve

more than one contract, often with their own separate arbitration clauses, such that arbitration agreements in these transactions are now less likely to be strictly followed. It may be possible to draft arbitration agreements favoring common rules and arbitral procedures across the various contractual agreements required in a transaction to render a potential arbitration simpler than court proceedings.

In sum, businesses entering into arbitration agreements should beware the risk of their counterparty's insolvency and the fact that any agreements to arbitrate may become inoperative. Following the lead from the SCC, Canadian courts will determine whether arbitration agreements are inoperative by applying a case-by-case analysis based on the factors set out in *Petrowest*. To mitigate that risk, straightforward arbitration agreements based on a common arbitral procedure and a single set of arbitral rules should be favoured, to avoid situations where a receiver or court concludes that arbitrating the dispute would be inefficient and "chaotic", as was found in *Petrowest*.

By

Philippe Boisvert, Matti Lemmens, Benedict S. Wray

Expertise

Commercial Litigation, Insolvency & Restructuring, Corporate Commercial

---