Construction Statutory Trusts in CCAA Sales

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Construction legislation in Ontario contains a number of clauses that provide for the creation of statutory trusts in favour of any person that provides material or services to a construction improvement. Specifically, under both the former *Construction Lien Act* (and now the *Construction Act*) ("CLA"), subsection 9(1) states that an amount equal to the proceeds from the sale of an owner's interest in the improvement constitutes a trust fund in favour of a contractor.[1] This subsection further provides that reasonable expenses incurred from the sale as well as amounts paid to discharge mortgages can be deducted from the proceeds. Subsection 9(2) goes on to state that the now former owner can neither appropriate nor convert any part of the trust funds for its own use or for any use inconsistent with the trust until the contractor is paid all the amounts owed to it in relation to that particular improvement.

The Ontario Court of Appeal recently had the opportunity to consider a s. 9(1) trust under the CLA within the context of a sale in ongoing insolvency proceedings in *Urbancorp Cumberland 2 GP Inc.(Re)*.[2] At the time of writing, it remains to be seen whether leave will be sought to appeal the decision to the Supreme Court of Canada.

The Cumberland Group ("Cumberland"), which consisted of various related companies, was a residential condominium developer. In 2011, one of Cumberland's entities, Edge on Triangle Park Inc. began developing the "Edge Profect" — a two tower residential condominium project with over 600 units. In 2015, Triangle sold a number of these units. By 2016, the entities forming the Cumberland Group, including Triangle, were in CCAA proceedings.

Units of the Edge Project continued to be sold during CCAA proceedings, further to various court orders. The sale proceeds, which exceeded $11 million, were used first to partially fund the ongoing insolvency proceedings and to repay the DIP lender. After further deducting for mortgage indebtedness, the balance of the proceeds stood at around $4.2 million.

At the time of the CCAA filing, certain contractors (the "Appellants") claimed that they were owed $3.8 million for unpaid work and materials that they had supplied to the Edge Project. The Appellants argued that the proceeds from the sale of these units

constituted a trust in their favour under s. 9(1) of the CLA. The Monitor applied for direction from the Court, and the motion judge held that a s. 9(1) trust did not arise, relying on the *Re Veltri Metal Products Co*. ("*Veltri*")[3] decision, which has been the subject of some debate over its correctness. The Appellants appealed the Motion Judge's decision, raising as well the additional constitutional issue of whether s. 9 of the CLA continued to apply in CCAA proceedings. The Attorney General intervened on that issue.
Justice Zarnett, writing for the Ontario Court of Appeal on behalf of a five member panel, allowed the appeal. He broke down his reasoning into three key issues.

First, on the constitutional question of whether a s. 9(1) trust is effective in insolvency, he limited his comments to the triggering of such trusts to sales occurring after the insolvency filing. He then applied the reasoning used in *The Guarantee Company of North America v. Royal Bank of Canada* ("*Guarantee*"),[4] (which built on the *Iona Contractors Ltd. v. Guarantee Company of North America*[5] decision of the Alberta Court of Appeal) in which the Ontario Court of Appeal considered whether funds impressed with the statutory trust created under s. 8(1) of the CLA would be excluded from distribution to creditors pursuant to the scheme contemplated by the *Bankruptcy and Insolvency Act* ("*BIA*").[6] Justice Zarnett observed that a s. 9(1) trust comports with the general principles of trust law. The subject matter of the trust is certain because s. 9(1) identifies the subject matter to be the sale proceeds, after deducting for expenses and amounts paid to discharge any mortgages. He noted that the object of the trust is certain as s. 9(1) identifies whom the trust is in favour of, namely the suppliers of services, labour and material. Finally, he observed that there was certainty of intention as s. 9 of the CLA provides for the creation of the trust and states that the funds cannot be used in a way that is inconsistent with the trust.

Justice Zarnett then went on to state that in applying the Guarantee decision, if a s. 9(1) trust can be effective in a proceeding subject to the BIA, then such a trust might be effective in a CCAA insolvency. He, however, also observed that following the Supreme Court of Canada's decision in *Sun Indalex Finance, LLC v. United Steelworkers*,7 a statutory trust may be wholly or partially ineffective if doing so would come into conflict with federal law (such as a specific priority in the CCAA), due to the doctrine of federal paramountcy.

Before coming to a conclusion on the constitutional question, Zarnett J. turned to discuss a second issue of whether *Veltri* was correctly decided. *Veltri* was a 2005 decision from the Ontario Court of Appeal and was relied upon by the motion judge in the case at hand. The motion judge observed that the Court in *Veltri* held that a s. 9(1) trust could not arise if a CCAA Monitor received the sale proceeds to be held for creditors. The motion judge concluded that *Veltri* applied because the Monitor here controlled both the sales process and the proceeds.

Justice Zarnett, writing here for the Court, explicitly stated that in his view, *Veltri* is correctly decided. He observed that *Veltri* had been read more broadly than what it stood for. In addition to discussing the facts in *Veltri*, amongst other things, he pointed out that a s. 9(1) trust could not have arisen in *Veltri* because the sale proceeds were less than the amount needed to discharge the debt. His view is that a s. 9(1) trust could not arise if there is no value to the consideration received for the sale of the premises, or if the mortgage debt is equal to or exceeds the sale proceeds. Justice Zarnett concludes that:

> Veltri does not stand for the proposition that the control by a CCAA Monitor of a sales process, or the receipt by the Monitor of the proceeds of sale, without more, prevents a s. 9(1) trust arising when the proceeds of sale of the improvement are shown to have a positive value that exceeds the mortgage debt on the property.[8]

Justice Zarnett also observed that the deemed receipt rule was not relevant to the reasoning in *Veltri*. As a result, Zarnett J. concluded that Veltri would not obligate him to reject the Appellants' claim here.

Turning to the third and final issue, Justice Zarnett discussed whether a s. 9(1) trust in fact arose here. He pointed to factors that supported his finding of a trust. These include the fact:

- that the sale of the units transferred all right, title and interest of Cumberland Group in the units to the purchasers;
- the sale proceeds exceeded the mortgage debt;
- the consideration received for the sale of the units could be attributed to the sale of property that was subject to a particular improvement; and
- the sale proceeds were received by the owner as the proceeds were placed into accounts opened for Triangle and another Cumberland Group entity.

Justice Zarnett then discussed whether other factors might displace the trust. He noted, among other things, that the initial CCAA Order provided that the Cumberland Group would remain in possession of its current and future assets. Although the Monitor had control over the sales process of the units, in Justice Zarnett's view, it was still the owner that sold its interest in the units and had received proceeds that exceeded its expenses and mortgage debt.

Justice Zarnett also observed that his view was not altered by the fact that the sale proceeds were used to pay CCAA proceeding expenses and the DIP lender. He noted that the remaining balance, following such payments, exceeded the amount owed to the Appellants. He also observed that charges under the CCAA, such as one in favour of the DIP lender, may take priority over a provincial statutory trust to the extent required to deal with the conflict.

Finally, he noted that the specific language in the Approval and Vesting Order regarding the sale of these units did not prevent a s. 9(1) trust from arising. Furthermore, the Order stated that sale proceeds would stand in place of the units (as if they had not been sold) with respect to determining stakeholders' priorities, and all claims and encumbrances would attach to these proceeds as if the unit had not been sold. The Order provided that purchasers' title would vest in the units free and clear of claims and encumbrances, as defined in the Order. Zarnett J. concluded that a s. 9(1) trust did not fall into the type of claims or encumbrances contemplated by the Order as both of these were defined terms.

As a result of the foregoing, Justice Zarnett concluded that a s. 9(1) trust applied to the sale proceeds in the sum of $3.8 million for the benefit of the Appellants.

Based on the comments of the Court of Appeal, it seems that the Court has been waiting for an opportunity to clarify its decision in *Veltri*. Urbancorp most definitely

provides further insight into the application of *Veltri* and also provides important direction for practitioners on the evolving law on construction trusts.

[1] See *Construction Lien Act*, R.S.O. 1990, c. C. 30, s. 9 and *Construction Act*, R.S.O. Chapter C. 30, s.9.

[2] 2020 ONCA 197 ("*Urbancorp*").

[3] (2005), 48 CLR (3d) 161 (Ont. C.A.).

[4] 2019 ONCA 9.

[5] 2015 ABCA 240, leave to appeal to the Supreme Court of Canada dismissed, [2015] SCCA No. 404.

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

[7] 2013 SCC 6.

[8] Urbancorp, supra note 2 at para 53.

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