Lien Issues and Insolvency

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1. INTRODUCTION

When a stakeholder in a construction project is insolvent, those owed money by the insolvent party will inevitably jockey for position in an attempt to ensure that their debts are given priority. Construction industry participants who are owed money on the project will often find themselves competing not only against each other, but against sophisticated creditors, such as financial institutions and the Canada Revenue Agency. Lien claimants are not immune to this maneuvering and can find themselves in a far more tenuous position than originally anticipated, their lien rights possibly stayed, and potentially faced with the prospect of participating in large and expensive insolvency proceedings subject to federal legislation. In such circumstances, the lien claimant must consider how their rights under provincial lien legislation stack up against the rights of other creditors whose rights and priorities are governed by federal legislation. This paper, written from the vantage point of the British Columbia legal practitioner, explores the intersection between lien legislation and insolvency law and offers a review of case law where lien claimants have had to assert their rights within the context of a larger insolvency situation.

2. BANKRUPTCY AND THE LIEN CLAIMANT

Under the *Bankruptcy and Insolvency Act*, R.S.C., 1985 c. B-3 ("*BIA*") when a company can no longer pay its debts, the company may voluntarily assign its assets to a trustee and file for bankruptcy or the debtor's creditors may file a petition forcing the debtor into bankruptcy. In either case, a trustee will be appointed, and the court will order a stay of proceedings while the trustee manages the insolvent's estate for the benefit of the creditors (s. 69 *BIA*).

The trustee in bankruptcy assumes management of the debtor's assets. Importantly, trust funds held by the bankrupt are excluded from the definition of debtor's assets (s. 67(1)(a) *BIA*). The result of this provision is that trust funds do not become the property of the trustee and will not be available for distribution of those creditors of the bankrupt who are not the trust's beneficiaries. The question that this poses in a lien context is whether the trusts created by provincial lien legislation constitute

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"property held by the bankrupt in trust for any other person" for the purposes of s.67(1)(a) of the *BIA* and as a result are not divisible amongst the creditors of the bankrupt estate.

In British Columbia for instance, the *Builders Lien Act* [SBC 1997] Chapter 45 (the "*BLA*") creates two forms of trust, either of which may allow the lien claimant to establish that certain funds do not fall within the bankrupt's estate.

First, pursuant to section 5(2)(a)(b) of the *BLA* all funds deposited into a holdback account "are charged with payment of all liens arising under the contractor from who the holdback was retained" and these funds are "held in trust" for the contractor.

Second, under section 10 all money "received by a contractor or subcontractor on account of the price of the contract or subcontract constitutes a trust fund for the benefit of persons engaged in connection with the improvement by that contractor or subcontractor and the contractor or subcontractor is the trustee of the fund."

Whether trust funds created under builder's lien legislation are exempt from a bankrupt's assets is not an entirely settled question across Canada although more recent decisions in British Columbia, Alberta, and Ontario have found that provincial lien legislation can create valid trusts that will survive bankruptcy: *0409725 B.C. Ltd., Re*, 2015 BCSC 1221 ("*Odenza*"), *Iona Contractors Ltd. (Receiver of) v. Guarantee Co. of North America*, 2015 ABCA 240, leave to appeal refused *Ernst & Young Inc. v. Guarantee Co. of North America*, 2016 CarswellAlta 660 (S.C.C.) ("*Iona Contractors*"), and *The Guarantee Company of North America v. Royal Bank of Canada*, 2019 ONCA 9 ("*GCNA*").

In *Odenza*, a builder of single-detached houses held a cash account with a balance of approximately $525,000 at the time it entered bankruptcy. Unpaid subcontractors and suppliers that provided work and materials for the builder's projects argued that the cash account was subject to a trust under section 10 of the *BLA*, as the funds were held by the builder for the benefit of the subcontractors and suppliers. The subcontractors and suppliers took the position that the cash account should be exempt from the builder's assets and not subject to ratable distribution to the unsecured creditors under the *BIA*.

The Court, after reviewing a number of the Supreme Court of Canada's decisions concerning paramountcy, including *John M.M. Troup Ltd. v. Royal Bank*, [1962] S.C.R. 487, *British Columbia v. Henfrey Samson Belair Ltd.*, [1989] 2 S.C.R. 24, and *Husky Oil Operations Ltd. v. Minister of National Revenue*, [1995] 3 S.C.R. 453, concluded that the *BLA* could

create a trust that was exempt under s. 67(1) of the *BIA*, provided the trust met the common law criteria to form a trust, namely: (1) certainty of intention; (2) certainty of object; (3) certainty of subject matter.

Certainty of intention exists if it is clear there was an intention to create a trust, and certainty of object exists if it is clear who the beneficiaries will be under the trust. The Court found that both of these requirements were easily established given the wording of the *BLA* trust provisions.

Somewhat more problematic for the Court was the third criteria for a common law trust – certainty of subject matter. For there to be certainty of subject matter, the trust property must either be described in the trust instrument or there must be a method for identifying it. The builder in this case, as in many construction related insolvency cases, had intermingled funds it had received for various projects and the moneys paid on account of one project had been paid out to trades on unrelated projects (at para 15):

> While the *BLA* [BC Lien Act] provides in section 11(7) that the commingling of finds is not of itself, a breach of trust, there can be no doubt that the use of funds received on one project to pay expenses on another is a breach, directly contravening section 10(2). The question is whether this affects the analysis of the extent of any trusts arising under the BLA. In my view, it does.
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> The first step to determine is what the initial cash balance comprises. Where did that money come from? In relation to what was it paid? If this cannot be determined with precision, does any purported trust fail for lack of certainty of subject matter? In that event the entire fund will fall into the bankrupt estate for distribution of the unsecured creditors.
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> Because the monies paid in respect of the various projects were commingled, Odenza's account books offer little assistance. What is clear is that money was paid out very quickly after it came in.

The Court ultimately concluded that despite these difficulties, the funds in the cash account did satisfy the common law requirement of certainty of subject matter. In doing so, the court made two key findings:

1. There was no doubt that all of the monies paid by the owners of the various projects were funds, that prior to bankruptcy were impressed with trusts pursuant to the *BLA* and the commingling of trust funds did not change this; and

> 2. Where a trustee acts in breach of trust in the mingling and spending of trust and non-trust funds, he is deemed to have spent his own money first, and trust money last.

In other words, the absolute certainty of the subject matter of the trusts when the funds were received by the builder could not be vitiated by the builder's breaches in handling of the funds and the builder's failure to distinguish between trust funds and non-trust funds (at para 24):

> I conclude in all the circumstances of this unusual case that the entire initial cash balance must be considered to comprise funds held in trust pursuant to the provisions of the BLA, which are to be distributed pro rata to all trust and lien claimants. Nothing remains for the trustee of the bankrupt estate.
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> I appreciate that this is of little comfort to owners such as M who paid funds in excess of existing lienable claims but will get nothing, and remain potentially liable for amounts they did not hold back in accordance with the requirements of the BLA. Regrettably, there is no way through this to a good outcome.

In *Iona Contractors*, the Alberta Court of Appeal reached a similar conclusion as the BC trial court did in *Odenza*. In this case, a general contractor had entered a contract with the Calgary Airport Authority. The general contractor declared bankruptcy during the course of the project leaving many sub-trades unpaid for their work. After the cost of correcting deficiencies was accounted for, the Airport still had funds totaling $997,716, which were owed under the contract to the bankrupt general contractor. The labour and material bond surety paid out $1.4 million to the sub-trades and sought to recover the $997,716 owed under the head contract, on the basis that it constituted trust funds for the benefit of the sub-trades and that the surety was subrogated to the sub-trades' interests, given the payment made under the bond to the sub-trades.

The Court of Appeal agreed with the surety and found that the trusts created by s. 22 of the Alberta Lien Act met the requirements of the general principles of trust law:

> 1. There is certainty of intention. The "intention" of s. 22 is to create a trust.
> 2. There is certainty of object. The beneficiaries of the trust are the unpaid subcontractors.

3. There is certainty of subject matter. Section 22 provides that once a certificate of substantial completion is issued, any "payment by the owner" is subject to the trust.

The Alberta Court of Appeal went on to find that the trust created by section 22 did not conflict with the priority scheme established pursuant to the *BIA* (at p.13):

> There is no deliberate attempt to reorder priorities in bankruptcy, and the province is not attempting to achieve indirectly what it cannot do directly. These considerations, coupled with the fact that the trust provisions of s. 22 are merely a collateral part of a complex regime designed to create security for unpaid subcontractors, leads to the conclusion that there is no operational conflict.
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> One of the objections to the statutory scheme in *Henfrey Samson Belair* was that the trust in question did not attach to any specific funds. It purported to attach to all the assets of the bankrupt tax collector as if it were a secured claim, like a type of general floating charge. The trust in s. 22 does not suffer from this deficiency, because it only attaches to the discrete sum of money paid by the owner after the certificate of substantial completion has been issued. The other assets of the owner (the Airport Authority) and the contractor (Iona) are unaffected. There is no attempt to throw a general trust over all the assets of the bankrupt.

Iona Contractors was appealed to the Supreme Court of Canada and leave was denied: 2016 CarswellAlta 660 (S.C.C.).

The Ontario Court of Appeal, sitting as a five-judge panel, reached a similar conclusion in *GCNA*. This appeal arose from a priority dispute between the creditors and employees of a bankrupt company, A-1 Asphalt Maintenance Ltd. ("A-1").

A-1 filed a Notice of Intention to make a proposal under the BIA on November 21, 2014. It subsequently failed to file a proposal and was deemed bankrupt on December 22, 2014. At the time of A-1's bankruptcy, it had four major ongoing paving projects with two municipalities and was owed nearly $700,000 by these municipalities for work already completed. Those funds were paid to the Receiver pursuant to a court order.

It was common ground on appeal that the funds constituted trust funds under the *Ontario Lien Act*. The dispute with respect to the ultimate beneficiary of those funds was between:

1. The Royal Bank of Canada, as a secured creditor of A-1 pursuant to a general security agreement.
2. The Guarantee Company of North America, a bond company and secured creditor of A-1 that had paid out twenty CLA lien claims (totalling $1,851,852.39) to certain suppliers and subcontractors of A-1 and was subrogated to those claims; and
3. Certain employees that worked on the Four Projects, as represented by LIUNA Local 183 and IUOE Local 793 (claiming a total of $511,949.14).

The motions judge had ruled that Guarantee Company of North America had failed to establish a trust claim and that the funds were not exempt from A-1's estate as the funds:

1. had not been segregated prior to payment to the Receiver; and

2. that the funds had not been held separately from other funds in order to maintain their character as trust funds.

The Court of Appeal reversed this ruling.

In doing so, it adopted the Alberta Court of Appeal's reasons in *Iona Contractors* and rejected the bank's position that the trust provisions of the Ontario lien legislation were an attempt by the Ontario government to reorder priorities in bankruptcy and was therefore unconstitutional. The Court held, as did the courts in *Iona Contractors* and *Odenza,* that the trust created by the Ontario lien legislation did not create a general priority over all of the bankrupt's assets but was specific to the debts owed to A-1 by the municipalities, to the extent of an unpaid obligations to subcontractors. Accordingly, there was no frustration of the purpose of the *BIA* that would render the trust provisions of the Ontario lien legislation inoperative.

With respect to the motion judge's finding that the requisite certainty of subject matter of the trust was absent as the funds had not come from any particular fund or account but were simply payable by the municipalities from their own revenues, the Court found (at para 82):

> The amounts owed by the City and the Town on account of the paving projects were debts. It is well-established that a debt

> is a chose in action which can properly be the subject matter of a trust. In *Citadel General Assurance Co. v. Lloyds Bank Canada*, 1997 CanLII 334 (SCC), [1997] 3 S.C.R. 805, at para. 29, the court stated: "A debt obligation is a chose in action and, therefore, property over which one can impose a trust". . .
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> It follows that it does not matter that neither the City nor the Town had created segregated accounts or specifically earmarked the source of the funds they would use to pay the debts they owed for the paving projects. The statutory trust attaches to the property of the contractor or subcontractor, namely the debt, not to the funds the debtor will use to pay that debt.
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> Section 8(1) embraces "all amounts, owing to a contractor or subcontractor, whether or not due or payable". That language designated precisely what property the trust is meant to encompass. A-1 owned those debts. They constituted choses in action which are a form of property over which a trust may be imposed. It follows that at the moment of A-1's bankruptcy, the trust created by s. 8(1) was imposed on the debts owed by the City and the Town to A-1.

Finally, the Court of Appeal rejected the motion judge's finding that, because the money paid to satisfy the individual debts owing to A-1 on account of the paving projects had been commingled with the money paid to satisfy other paving project debts in the Paving Projects Account, the requisite certainty of subject matter was not made out. The Court of Appeal found that the evidence clearly established that the funds paid for each paving project were readily ascertainable and identifiable. They were commingled only to the extent they had all been paid into the same account but they had not been converted to other uses and they did not cease to be traceable to the specific project for which they had been paid. The Court found (at para 87):

> Commingling of this kind does not deprive trust property of the required element of certainty of subject matter. Commingling of trust money with other money can destroy the element of certainty of subject matter, but only where commingling makes it impossible to identify or trace the trust property.

Accordingly, and as with the Courts in British Columbia and Alberta, the Ontario Court of Appeal held that the statutory trusts created by the Ontario lien legislation will survive bankruptcy where they exhibit the three features of a trust (certainty of intention, subject matter, and object), in accordance with the common law.

In Saskatchewan the courts have taken a different approach most notably in *Duraco Window Industries (Sask.) Ltd. v. Factory Window & Door Ltd. (Trustee of)* (1995), 23 C.L.R. (2d) 239 (Sask. Q.B.) and *Roscoe Enterprises Ltd. v. Wasscon Construction Inc.* (1998), 41 C.L.R. (2d) 54 (Sask. Q.B.). In these two decisions the Saskatchewan courts held that s. 67(1) of the *BIA* did not apply to trusts created by provincial lien legislation and as a result, moneys received by a bankrupt contractor from its customers and deposited into an account, belonged to the trustee in bankruptcy and not those persons who would otherwise be trust beneficiaries under the provincial lien act. However, these decisions have now been specifically distinguished by the trial court in British Columbia (*Odenza*), and the appellate courts in Alberta (*Iona Contractors*) and Ontario (*GCNA*) and are therefore unlikely to have much influence outside of Saskatchewan.

3. CCAA PROCEEDINGS AND THE LIEN CLAIMANT

The *Companies Creditors Arrangement Act* R.S.C. 1985 c. C-36 (the "*CCAA")* provides insolvent companies with debts of $5 million or more with temporary protection from creditors while they attempt to restructure. In contrast to the *BIA,* the *CCAA* affords considerable flexibility to debtor companies and provides courts with broad jurisdiction to make orders in respect of claims against them.

In *Hongkong Bank of Canada v. Chef Ready Foods Ltd.*, 1990 CarswellBC 394 (C.A.), the BC Court of Appeal explained that the chief objective of the *CCAA* is to continue the operation of the debtor company as a going concern so that it can satisfy its creditors:

> The purpose of the C.C.A.A. is to facilitate the making of a compromise or arrangement between an insolvent debtor company and its creditors to the end that the company is able to continue in business... When a company has recourse to the C.C.A.A. the court is called upon to play a kind of supervisory role to preserve the status quo and to move the process along to the point where a compromise or arrangement is approved or it is evident that the attempt is doomed to failure.

In *Ted Leroy Trucking Ltd., Re*, 2010 SCC 60, the Supreme Court of Canada further added that the broad powers afforded to the court distinguish the *CCAA* from the *BIA*:

> [19] . . . During the economic downturn of the early 1980s, insolvency lawyers and courts adapting to the resulting wave of insolvencies resurrected the statute and deployed it in

> response to new economic challenges. Participants in insolvency proceedings grew to recognize and appreciate the statute's distinguishing feature: a grant of broad and flexible authority to the supervising court to make the orders necessary to facilitate the reorganization of the debtor and achieve the *CCAA*'s objectives.

The principal instrument of the *CCAA* is the initial order which creates a stay of proceedings. In *Doman Industries Ltd., Re*, 2003 BCSC 376 (In Chambers), the Court found that there were three purposes of the initial order. First, it maintains the status quo among creditors while the company attempts to reorganize its affairs. Second, it prevents creditors or others from acting on the insolvency of the debtor company or other contractual breaches caused by the insolvency to terminate contracts or accelerate payment where that would interfere with the debtor company's ability to reorganize its affairs. Third, it is designed to relieve the debtor company of the burden of dealing with litigation against it so that it can concentrate on its restructuring.

Typically, the initial order will contain a reorganization of priorities and interim debtor-in-possession (DIP) financing and, unless it specifically exempts the enforcement of lien rights, can prevent even registration of liens. In British Columbia, the *CCAA Model Initial Order* does not stay the registration of liens:

> Nothing in this Order, including paragraphs [15] and [16], shall: (i) empower the Petitioner to carry on any business which the Petitioner is not lawfully entitled to carry on; (ii) affect such investigations, actions, suits or proceedings by a regulatory body as are permitted by Section 11.1 of the CCAA; (iii) prevent the filing of any registration to preserve or perfect a mortgage, charge or security interest (subject to the provisions of Section 39 of the CCAA relating to the priority of statutory Crown securities); or (iv) prevent the registration or filing of a lien or claim for lien or the commencement of a Proceeding to protect lien or other rights that might otherwise be barred or extinguished by the effluxion of time, provided that no further step shall be taken in respect of such lien, claim for lien or Proceeding except for service of the initiating documentation on the Petitioner
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> [emphasis added]

If, however, the initial order does not contain such language, an application must be made in the *CCAA* proceeding to lift the stay for the purpose of preserving specific lien rights.

In 2019, the *CCAA* was amended to reduce the length of the stay in an initial order from 30 days to 10 days (s. 11.02(1)). Though the debtor company can later apply for a further order staying proceedings for any period the court considers necessary (s. 11.02(2)).

In addition to potentially jeopardizing the ability to register or enforce liens, *CCAA* proceedings can have other substantive implications for lien claimants by deprioritizing their lien rights. In particular, a *CCAA* court may order administrative charges, director charges or DIP financing in order to protect the debtor company. These charges will typically be granted "super priority" over other creditors, including lien claimants.

Any uncertainty in the law with respect to whether a court may grant "super priority" to certain charges and financing was eliminated in 2009, when the *CCAA* was amended to include section 11.2, which specifically provides that the court may order that the security or charge made in favour of a person who agrees to lend to the company an amount approved by the court rank in priority over the claim of any other secured creditor.

The discretion to make such an order is very broad. In *9354-9186 Québec inc. v. Callidus Capital Corp.*, 2020 SCC 10, the Supreme Court of Canada said the following about the discretion afforded by section 11.2 of the *CCAA:*

> Ultimately, whether proposed interim financing should be approved is a question that the supervising judge is best-placed to answer. The *CCAA* sets out a number of factors that help guide the exercise of this discretion. The inclusion of these factors in s. 11.2 was informed by the Standing Senate Committee on Banking, Trade and Commerce's view that they would help meet the "fundamental principles" that have guided the development of Canadian insolvency law, including "fairness, predictability and efficiency" (p. 103; see also Innovation, Science and Economic Development Canada, cl. 128, s. 11.2). In deciding whether to grant interim financing, the supervising judge is to consider the following non-exhaustive list of factors:
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> **Factors to be considered**
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> (4) In deciding whether to make an order, the court is to consider, among other things,
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> **(a)** the period during which the company is expected to be subject to proceedings under this Act;

> **(b)** how the company's business and financial affairs are to be managed during the proceedings;
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> **(c)** whether the company's management has the confidence of its major creditors;
>
> **(d)** whether the loan would enhance the prospects of a viable compromise or arrangement being made in respect of the company;
>
> **(e)** the nature and value of the company's property;
>
> **(f)** whether any creditor would be materially prejudiced as a result of the security or charge; and
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> **(g)** the monitor's report referred to in paragraph 23(1)(b), if any.

As loans granted super priority will more than likely subordinate the rights of the lien claimant, a claimant may have to seriously consider appearing in the *CCAA* proceeding to challenge whether the loan or amount thereof is reasonable and necessary, having regard for the factors set out in s. 11.2(4) and the relevant authorities: See for example *Comstock Canada Ltd., Re*, 2013 ONSC 4756 (S.C.J.).

In *Kerr Interior Systems Ltd., Re*, 2009 ABCA 240, the Alberta Court of Appeal considered whether two lien claimants were entitled to secured creditor status in a *CCAA* proceeding concerning Composite Buildings Systems Inc. (''Composite'') and Kerr Interior Systems Ltd. (''Kerr'').

Composite and Kerr fabricated and installed walls, ceilings and partitions for a project in Saskatoon owned by a numbered company (the ''Project''). Kenroc Building Materials Co. Ltd. (''Kenroc'') and Superior Plus LP and Winroc (''Winroc'') supplied materials to Composite and Kerr for the Project. Both suppliers filed liens for amounts owing for the materials. Winroc's lien was filed before the *CCAA* protection order, whereas Kenroc's lien was filed after the order.

The Court of Appeal found that neither Winroc nor Kenroc were secured creditors on account of the lien, as the *CCAA* order required the security to be in the property of the debtor company, whereas the liens were secured as against property which was owned by the numbered company (a separate entity from the debtor company).

The majority found that both Winroc and Kenroc were nonetheless entitled to secured creditor status on account of the trust provisions in the Saskatchewan *Lien Act*, which imparted a trust on funds owed by the numbered company to Kerr as the definition of a ''secured creditor'' in

the *CCAA* includes the holder of a trust in respect of, all or any property of the debtor company (at para 16):

> In short, Kenroc's equitable interest in the monies owed to it by Kerr constituted a trust in respect of the property of Kerr, being the latter's equitable interest in the monies owed to it by 101, such as to constitute Kenroc a secured creditor within the meaning of section 2 of the CCAA. The trust attached to the contractor's receivable, which is property of the contractor, and thereby falls within the CCAA definition of secured creditor.
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> The filing of the lien was not necessary to perfect the trust obligation, which was independent of the lien. The amount owed to Kenroc was ascertainable as at November 7, 2007. It was the amount of $103,236.98, and that is the extent of the trust interest (subject to adjustments). The determination of the exact amount owing under a secured instrument on a given date is commonplace and does not create any uncertainty.
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> The trust fund obligation was "reasonably ascertainable" at the material date. In *British Columbia v. Henfrey Samson Belair Ltd*, [1989] 2 S.C.R. 24, McLachlin J., as she then was, speaking for the majority, stated at para. 19 that whether a statute created a trust depends on the facts of the particular case. She added that if the money collected is "identifiable or traceable", then a trust within the ordinary meaning of that term should be given effect. Here, pursuant to the Saskatchewan statute, the monies owed by 101 to Kerr, and in turn owed by Kerr to Kenroc, are impressed with a trust. All of these amounts were readily ascertainable or identifiable as at November 7, 2007.

The majority concluded by noting it was reluctant to construe the *CCAA* in such a manner as to defeat the trust obligations imposed by the Saskatchewan legislation in favour of subcontractors, given that the legislation clearly intended to give these types of trusts a broad and early scope.

4. CRA THIRD PARTY DEMANDS AND THE LIEN CLAIMANT

An insolvent contractor or owner is very likely to fail to stay current with payments owing to the Canada Revenue Agency (the "CRA"). When this happens, it gives rise to claims by the CRA, which also may defeat the interests of lien claimants.

Section 277 of the *Income Tax Act* ("*ITA*") provides Her Majesty with a deemed trust in respect of certain payments that must be made to the CRA. One such payment is found in s. 153 *ITA*, which requires employers to deduct income tax from their employees' payroll. The law is clear that the deemed trust claims of Her Majesty under the *ITA* take priority over lien claims under provincial lien acts*: TransGas Ltd. v. Mid-Plains Contractors Ltd.*, 1993 CarswellSask 414 (C.A.), additional reasons 1993 CarswellSask 635 (C.A.), affirmed 1994 CarswellSask 451 (S.C.C.)*; Ledcor Design-Build Saskatchewan Ltd. v. Comfort Structures Ltd.*, 2018 SKQB 273*; Ledcor Construction Ltd. v. 544033 B.C. Ltd.*, 2006 BCSC 2097 (In Chambers).

The CRA may also serve a Requirement to Pay ("RTP") under section 224(1.2) of the *ITA* on a third party, which obliges it to take any funds due, or that shall become due, to the tax debtor, and pay them to the CRA. Essentially, the RTP is a means by which the CRA can garnish a third-party debtor of a tax debtor.

In the context of a construction project, a RTP may be served on the owner of the project after a contractor fails to make remittances to the CRA. If the holdback is owing to the contractor, the CRA can oblige the owner to pay the holdback fund directly to it, leaving the lien claimants empty handed.

Often a contractor that has defaulted on its taxes has also defaulted in fulfilling its obligations under the building contract. This was the case in *PCL Constructors Westcoast Inc. v. Norex Civil Contractors Inc.*, 2009 BCSC 95. In accordance with the BLA holdback provisions, the general contractor, PCL, had heldback funds under Norex's subcontract. Norex defaulted on its contract and PCL hired a new subcontractor to complete the work. Liens were registered by two sub-subcontractors under Norex's subcontract and PCL paid approximately $28,000 in holdback funds into court to have the liens discharged from title. The CRA served an RTP on PCL for $908,315.88 due to Norex's tax arrears.

The CRA argued that the holdback funds were subject to a deemed trust arising under s. 227(4) of the *ITA* in favour of Her Majesty, and that this trust ranked in priority above the lien claims. PCL took the position that no amounts were owing to Norex due to Norex's default under the contract and PCL's right of equitable set off. PCL argued it was entitled to set off the value of the work completed by the new subcontractor against the holdback and given that the value of this work exceeded the amount of the holdback there were no funds that could be the subject of the deemed trust or RTP.

The BC Supreme Court agreed with PCL and determined that the doctrine of setoff operates to reduce the principal amount owing to a creditor:

> [53] Equitable setoff is not a complicated legal device - it is a simple mechanism for ensuring that parties to a contract only pay or get paid what is due or owing under the contract. It would be unfair if a Sub-contractor who completes work for a Contractor, but who in the process causes damage to the Contractor equal to the value of the work done, had to first be paid before the Contractor could sue for damages. When setoff is claimed, therefore, it means that the amount owed under the contract, if any, is unclear and that claim must be determined before the Sub-contractor becomes entitled to the holdback fund.

The court held that the CRA's entitlement to the holdback was no greater than the sub-contractors. The sub-contractor's right to the holdback was conditional upon the rights of lien claimants and the rights of PCL to an equitable set off - the CRA's right could be no greater. However, the Court reconfirmed that the CRA's claim ranked ahead of the lien claimants in priority.

The Court summarized the exercise as follows:

> [67] If the CRA is not entitled to seize the holdback, as I have held, the outcome depends on whether the Sub-contractor is entitled to receive the holdback. Before any setoff may be claimed, the Contractor is required by s. 6 to discharge the liens, which it can do by paying the holdback fund into court. The portion of the holdback to which the Sub-contractor is entitled can then be determined by subtracting the amount of the setoff. If the setoff is larger than the holdback, the Sub-contractor has no entitlement, and the Sub-subcontractors' lien claims will be satisfied from the fund. If the setoff is smaller than the holdback, the Sub-contractor's entitlement is equal to the amount of the holdback minus the setoff. Because the CRA's claims take priority over the lien-holders, it is then entitled to claim any funds to which the Sub-contractor would have been entitled but for the claims of the Sub-subcontractors. The Sub-subcontractors are then entitled to the remainder, i.e. the amount of the Contractor's setoff, if any. Therefore, the result is arbitrary insofar as whether the Sub-subcontractor is paid from the holdback depends on whether

> the Sub-contractor is entitled to the money, i.e. the precedent determining the result and the result are entirely unrelated.

Assume, for example, a situation where the holdback is $100,000, there is a RTP for $70,000, a lien claimed for $20,000, and the owner is entitled to a setoff of $10,000. The first step is to apply the owner's right of setoff, as this reduces the contractor's entitlement. Deducting $10,000 from the $100,000 holdback leaves $90,000 available to the CRA and lien claimants. Then, the CRA receives its share first and take $70,000 of the remaining $90,000. Finally, the balance of $20,000 is left for the lien claimants.

In the above example, the holdback was sufficient for all parties to receive what was owed to them, but that often will not be the case. For example, in *Okanagan Regional Library v. Isaak Electrical Ltd.*, 2013 BCSC 953, the CRA claimed an amount greater than the owner's holdback. A lien was registered before an RTP was served, but the owner had failed to pay the holdback funds into the court before the RTP was served. As the owner had no equitable right of setoff the RTP attached to the entirety of the holdback and the holdback funds were to be paid to the CRA. This left the owner in the unhappy situation of paying out of pocket to remove the lien.

In both *PCL Constructors Ltd.* and *Okanagan Regional Library*, the courts commented on the arbitrary result that arises depending on when the CRA serves the RTP. If the RTP is served before the holdback is paid into court to discharge the liens, then the CRA will claim the holdback funds and the owner will be required to pay additional funds to remove the liens. On the other hand, if the holdback is paid into court and the liens are removed before the RTP is served, then the CRA will claim the funds paid into court, leaving the lien holders out of luck.

In *PCL Constructors Westcoast Inc. v. Norex Civil Contractors Inc.*, the court stated:

> I pause here to note that arbitrary results follow whether or not I hold that the CRA is entitled to the holdback via the deemed trust. If the CRA were able to seize the holdback fund under any circumstances, then if the Contractor manages to pay the holdback into court before the CRA lays claim to the fund, it will have discharged its liability under s. 23. The party that will be unpaid will then be the Sub-subcontractors holding *BLA* liens. However, if the CRA manages to seize the fund before it has been paid into court, the liens remain on the Contractor's property, not having been discharged under s. 23, and the Contractor must still pay the amount of the holdback

> to satisfy the liens. The result is arbitrary insofar as the party ultimately liable for the amount of the holdback, whether the Contractor or the Sub-subcontractor, depends on the CRA's timing in asserting its claim.
>
> ... [I]n my view, this fact and the arbitrariness of the results that flow from either conclusion are an unfortunate reality generated by two legislative schemes from two levels of government, each designed without the other in mind. It is left to this court to rule on the consequences of their interaction in as principled a manner as possible

5. CONCLUSION

In conflicts between lien acts and the *BIA* with respect to whether a statutory trust has been created that will exempt funds from the bankrupt's estate, the issue will likely turn on whether lien claimants will be able to satisfy the third common law requirement of a trust - certainty of subject matter. The controversy here will continue to be whether the funds alleged to constitute trust funds can be traced to the project and contract in question. If lien claimants are unable to establish this with some certainty, there is significant risk that the funds will fall into the bankrupt's estate and lien claimants will simply be one more unsecured creditor in the bankruptcy.

Similar considerations will arise under the *CCAA* albeit in a context where lien claimants are faced with the prospect of attempting to obtain secured creditor status pursuant to section 2 of the *CCAA*. However, even where lien claimants have been able to establish the existence of a trust sufficient to establish them as a secured creditor, lien claimants are still faced with the real possibility of their ultimate recovery being whittled away by operation of the super priority status of payments authorized by a *CCAA* Court.

Finally, the super priority status granted to the CRA pursuant to the *ITA* can pose an even greater challenge to lien claimants when there are unpaid amounts owed by a project participant to the CRA - a not uncommon scenario in construction insolvencies. The entirely arbitrary result of which project participant will bear the burden of an RTP served in the context of an insolvency has, as of yet, no satisfactory rationale in the case law.

It is widely appreciated that time is of the essence when asserting lien rights under lien legislation. When a stakeholder in a construction project is facing insolvency the need to move quickly is critical.

Perfecting lien rights before protection and stay orders are implemented and paying holdback funds into court before RTPs are served can help lien claimants and owners reduce their exposure to losses arising from the insolvency of a construction project participant. Those that fail to move with haste will risk having their interests debased to more sophisticated creditors.