

# An Overview of Insolvency Proceedings in the Context of the Construction Industry

**Authors: Melanie LaBossiere Ross McFadyen**

*published 02/08/2023*

Builders' lien and statutory trust issues are complex in the best of circumstances. Cash flow issues, financial distress, and insolvency during a construction project only work to further complicate these issues.

When a party involved in a construction project seeks creditor protection, or is placed in an insolvency process by a creditor, the effect on the project and other parties can be significant.

Generally, when insolvency proceedings commence, a creditor's first questions are:

1. will I get paid?
2. where do I stand in the line of creditors?
3. is there anything I can use to jump ahead of other creditors and/or maximize my recovery?

The answers to these questions are largely fact-specific and depend heavily on the type of insolvency proceeding and the identity of the insolvent or bankrupt party (i.e. contractor, owner etc.). With the right guidance from insolvency professionals, outcomes do not always have to be catastrophic.

This article provides a brief overview of the various insolvency proceedings in Canada, and the use and effectiveness of builders' liens and statutory deemed trusts under *The Builders' Liens Act*, CCSM c B91 (the "**Act**") in an insolvency proceeding.

## Insolvency Proceedings in Canada

In Canada, there are two legislative frameworks that dictate the form of an insolvency proceeding: the *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 (the "**BIA**") and the *Companies' Creditors Arrangement Act*, RSC 1985, c C-36 (the "**CCAA**").

Under the BIA, there are three distinct insolvency processes: bankruptcy, proposal proceedings and receivership.



Additionally, the CCAA sets out a restructuring process specifically for large businesses.

The purpose and effect of each of the four insolvency proceedings differ.

## **Bankruptcy**

Bankruptcy proceedings provide a mechanism for the orderly liquidation of a bankrupt's estate and the distribution of the property of a bankrupt among creditors.

In this respect, the BIA assists with collective action problems that creditors would otherwise face in attempting to recover their claims by preventing a premature race to the debtor's assets. Instead, a licensed insolvency trustee is given an opportunity to realize on assets and satisfy creditor claims in accordance with a distribution scheme set out in the BIA.

Importantly, bankruptcy is a process designed to deal with the claims of unsecured creditors. Secured creditors are generally not impacted by a bankruptcy. Accordingly, if a debtor has insufficient assets available to satisfy the claims of its secured creditors, the bankruptcy process is typically not engaged at all.

## **Proposal Proceedings**

Proposal proceedings under the BIA are designed for the reorganization of business entities that are insolvent but may still be viable in an operational sense after the approval of a proposal. The ultimate goal of reorganization under the BIA is to permit insolvent debtors to avoid (or postpone) bankruptcy by making a proposal to its creditors to resolve its debts. Unlike a bankruptcy, a debtor remains in possession of its assets and business operations. However, the proposal trustee is appointed to monitor the debtor during the course of the proceedings.

The BIA establishes clear rules on proposals to better allow a debtor to negotiate payment arrangements with creditors. A proposal settles the priorities of creditors. If the proposal is accepted by a requisite number of creditors and approved by the court, that settlement cannot be challenged by creditors. Although a proposal is a formal process involving the court, an accepted and approved proposal effectively gives rise to a new contract between the debtor and its creditors.

## **Receivership**

The purpose of a receivership is to provide a mechanism for the timely, efficient and impartial resolution of a debtor's insolvency. It is a process that is typically initiated by a secured creditor of a debtor. A receiver is appointed to preserve and maximize the value of a debtor's assets, ensure fair and equitable treatment of the claims against a debtor, protect the public interest, and balance the costs and benefits of restructuring or liquidating. In this

respect, the primary task of a court-appointed receiver is to ensure that the highest value is received for the debtor's assets so as to maximize the return to the creditors.

## **CCAA Restructuring**

A restructuring under the CCAA gives insolvent companies the opportunity to avoid bankruptcy and restructure their affairs for the benefit of stakeholders. Unlike a bankruptcy or receivership, but similar to proposals, the purpose of a CCAA process is to allow a company (and/or affiliated companies) to continue to operate, restructure itself, and create a plan for a more financially sustainable and operational model going forward.

The CCAA is restricted to larger companies owing in excess of \$5,000,000.00 to creditors. Companies that do not reach the \$5,000,000.00 threshold can utilize proposal proceedings under the BIA.

## **Overarching Purpose**

Ultimately, each process provides a debtor and its assets with immediate protection against the actions of creditors in order to facilitate the fair and orderly resolution and/or compromise of creditor claims.

To achieve this purpose, it is paramount that the debtor and the debtor's assets are protected from the risk of multiple creditors taking or continuing action against the debtor and/or the debtor's assets to collect on their claims.

As such, the most significant effect of the commencement of insolvency proceedings is the imposition of an automatic stay of proceedings against the debtor and the debtor's property. This automatic stay of proceedings arises from specific provisions of the BIA and CCAA, and/or by orders of the court. Notably, a stay of proceedings does not apply to a secured creditor in the context of a bankruptcy proceeding.

The stay of proceedings generally extends to protect the debtor corporation, its assets and its directors and officers.

A creditor may apply to the court for a declaration that the stay provisions of the BIA or CCAA, or an Order made by the court no longer operate in respect of the creditor. The stay may be lifted regarding a creditor if the court is satisfied that the creditor is likely to be materially prejudiced by the continued operation of the stay, or that it is equitable to make such a declaration.

Notably, initial orders made by the court in proposal, receivership, and CCAA proceedings generally include an exception which sets out that while all rights and remedies of any person against or in respect of the debtor, the trustee, monitor or receiver, or the property of

the debtor, are stayed and suspended, nothing in the order shall prevent the registration of a claim for lien. However, any action to prove or enforce a claim for lien remains stayed absent an order lifting the stay of proceedings. This exception does not apply in a bankruptcy.

## Builders' Liens and Statutory Deemed Trusts in Insolvency

Builders' liens and statutory deemed trusts under the Act are important protections for those who perform work or services or supply materials to improve the value of land. The basic principles regarding the Act are discussed in previous articles "**Rights and Responsibilities under The Builders' Liens Act**" and "**Builders' Lien F.A.Q.**"

In an insolvency proceeding, the protections that may otherwise be available under the Act may not be effective and/or valid.

It is important to note that insolvency proceedings are designed to protect the property of an insolvent debtor or bankrupt to allow the debtor or court-appointed officer (trustee, receiver etc.) to preserve and/or realize on property of the debtor for the benefit of creditors and stakeholders.

In a proposal or bankruptcy proceeding, section 136 of the BIA provides a priority rule which is used to determine the order in which various creditors who, subject to the rights of secured creditors, hold an interest in property of the bankrupt will be paid from proceeds realized from the bankrupt entity's assets.

The distribution scheme under the BIA has been upheld in cases involving a conflict between the distribution scheme under the BIA and a priority mechanism provided by provincial legislation.

However, provincial legislation may play an integral role in the distribution of assets (albeit indirectly) as provincial property legislation determines the rights of a creditor in relation to a particular asset, and provincial contract laws determine whether a debt is actually owed to a creditor by a debtor. Essentially, provincial legislation governs the relationship between creditors and debtors, as well as each party's proprietary interests in a particular asset, but cannot be used to alter the distribution scheme or create new priorities under section 136 of the BIA.

As such, while a creditor may establish a priority in non-bankruptcy matters through the operation of provincial legislation, such as the Act, a creditor will not necessarily be permitted to enjoy the benefit of the priority provisions in a bankruptcy or proposal proceeding.

## Statutory Trusts under the Act

Trusts under the Act serve to protect the interests of contractors, sub-contractors and suppliers by protecting funds that are owed to or have been received by another party.

The BIA expressly recognizes that property held in trust for another person is not “property of the bankrupt” and therefore, does not form part of the bankrupt’s estate to be distributed among creditors.

While the BIA recognizes the effects of an express trust and removes any property held in trust from the debtor's estate (and therefore out of the hands of creditors), a deemed trust under provincial legislation, such as the Act, will not automatically provide the benefit that it would outside of an insolvency proceeding.

In order for a statutory trust under the Act to be recognized as a valid trust in an insolvency proceeding, it must meet the three certainties of a common law trust. That is, certainty of intent, certainty of subject matter and certainty of object. This requires a clear intention to create the trust, (generally) a separate and distinct trust fund / account holding the trust property separately from other funds of the debtor, and clearly defined beneficiaries of the trust.

Previously, these requirements were strictly enforced by courts. For example, various courts across Canada have found that the failure of a contractor, owner, or sub-contractor to segregate trust funds had the effect of defeating any argument that certain funds are trust property for the purposes of an insolvency proceeding, even if the funds would have been considered trust funds under the Act outside of an insolvency proceeding.

However, there is recent case law out of Ontario which suggests that the mere commingling of funds does not automatically result in a trust claim being defeated, but rather a trust claim would be defeated only when commingling is accompanied by conversion and tracing becomes impossible. It is unclear whether this law out of Ontario would be accepted by a court in Manitoba.

Additionally, courts have lifted a stay of proceedings to allow a party to pursue the directors and officers of an insolvent corporation, personally, for breach of trust under the Act, where a trust claim over the funds of the insolvent or bankrupt corporation was unsuccessful.

Finally, under section 178(1)(d) of the BIA, debts which arise out of fraud, embezzlement, misappropriation or defalcation while acting in a fiduciary capacity survive bankruptcy. Therefore, courts have found that a creditor may be entitled to pursue a claim against a discharged bankrupt for breach of trust on the basis that the claim survived bankruptcy.

Ultimately, the issue of whether funds constitute trust property for the purposes of insolvency proceedings, or whether claims can be advanced outside of or after an insolvency proceeding

is complex and highly fact-specific. It is beneficial to have an insolvency professional review a matter in order to ensure that you are aware of what claims you may have and how to best advance those claims.

## **Builders' Liens**

A builders' lien is a right "in rem". That is, a right that exists in relation to certain property. Liens give sub-contractors and suppliers the right to assert a claim directly against the owner's property.

The Act provides that a lien claimant has a lien for the price of unpaid work and materials that attaches to the interest of the owner in the land, so long as that lien claim is registered within the timeline prescribed by the Act.

A builders' lien enables unpaid contractors, sub-contractors and suppliers to seek payment directly from the owner of the property to which they contributed work, services or materials, regardless of whether the parties have a direct contractual relationship with the owner.

While lien claimants may be creditors of an insolvent contractor or sub-contractor in respect of unpaid work and materials, the security the lien claimant holds in those circumstances is not against the property of the debtor but rather against the property of the owner.

Therefore, a lien claimant cannot assert that it has a priority over other creditors of an insolvent or bankrupt contractor by reason of a lien under the Act, as the lien attaches to the third party owner's property, which cannot be used to satisfy the claims of the debtor's creditors in an insolvency proceeding

However, a lien claimant with a claim against an insolvent or bankrupt contractor can proceed with its lien claim against an owner (who is not insolvent or bankrupt) separate and apart from filing a claim in the bankruptcy or proposal proceedings of the contractor, as the stay of proceedings arising as a result of the contractor's insolvency proceedings does not extend to cover the owner.

Courts have held that a lien claim under provincial builders' liens legislation may be proven in a claims process in an insolvency proceeding. The burden of establishing a valid lien claim is on the lien claimant. If a valid lien claim is established, the lien claimant is considered a secured creditor and is given priority over unsecured creditors to the proceeds of the sale of the property to which the lien has attached. If the proceeds from the sale of the property are not sufficient to cover the full value of the lien claim, then the lien claimant may seek to recover the shortfall as an unsecured creditor.

## Conclusion

Builders' lien and statutory trust issues are complex and highly fact-specific. We recommend that you speak to a lawyer with experience in bankruptcy, insolvency and restructuring to assist with such situations to ensure that you are aware of your rights, the available options and to maximize your recovery.

It should be noted that claims processes in insolvency proceedings may have very strict timelines. Failing to file a claim may significantly impair your ability to recover. As such, contact a lawyer as soon as possible to ensure that claims are made within any applicable claim period.

**Melanie LaBossiere** is a civil litigation and dispute resolution lawyer with a practice focused primarily in the areas of insolvency and bankruptcy law, corporate restructuring, construction law and insurance law.

**Ross McFayden** is a partner at TDS who practises in the area of civil litigation, with an emphasis on insolvency and restructuring, and commercial disputes.

---

**DISCLAIMER:** *This article is presented for informational purposes only. The content does not constitute legal advice or solicitation and does not create a solicitor client relationship. The views expressed are solely the authors' and should not be attributed to any other party, including Thompson Dorfman Sweatman LLP (TDS), its affiliate companies or its clients. The authors make no guarantees regarding the accuracy or adequacy of the information contained herein or linked to via this article. The authors are not able to provide free legal advice. If you are seeking advice on specific matters, please contact Keith LaBossiere, CEO & Managing Partner at [kdl@tdslaw.com](mailto:kdl@tdslaw.com), or 204.934.2587. Please be aware that any unsolicited information sent to the author(s) cannot be considered to be solicitor-client privileged.*

*While care is taken to ensure the accuracy for the purposes stated, before relying upon these articles, you should seek and be guided by legal advice based on your specific circumstances. We would be pleased to provide you with our assistance on any of the issues raised in these articles.*