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A TICKING TIME BOMB: WHAT YOU NEED TO KNOW ABOUT THE NEW LIMITATIONS ACT

by Stephen Thiele

On January 1, 2004, a new *Limitations Act* came into force in Ontario. Although many lawyers have welcomed the passage of the new Act, one section in particular, s. 22, has been widely criticized on the basis that it is out of step with commercial realities. Generally, this section prohibits persons from contracting out of the limitation periods found in the Act.

Before discussing the ramifications of s. 22, it is important to note the basic changes that the new Act makes to the law of limitation periods and to highlight their impact on certain commercial parties.

Pursuant to s. 4, the new Act establishes a two-year limitation period for most causes of action. Under the old Act, the limitation period for contractual and tort claims was six years. Section 15 of the new Act also introduces an ultimate limitation period of 15 years. The new Act contains some exceptions to the two-year and 15 year periods and there is a provision dealing with the issue of when the limitation period does not run. Transition provisions also exist, preserving the old periods where applicable.

The basic two-year limitation period and s. 22 have an enormous impact on the business community. Where a party now is faced with a breach of contract, an action must be commenced within two years of the breach. Although the concept of discoverability is codified in the new Act, it is unlikely to arise in most breach of contract claims since parties generally become aware of a contractual breach at the time of the breach.

Promissory notes are often used to evidence a loan and to enforce payment. Lenders that have a habit of utilizing promissory notes payable on demand are impacted by the changes in the new legislation since these kinds of notes create an obligation to pay from their date of execution. Thus rather than the limitation period beginning to run from the date of a formal demand, the limitation period begins to run immediately from the day the note is created. The two-year period will put pressure on lenders who get on demand promissory notes to ensure that the two-year period does not expire either before getting new notes or obtaining written acknowledgements from the debtor. The issuance of new notes and the receipt of written acknowledgements will trigger the running of new limitation periods.

For those involved with the enforcement of debts, the new Act removes the previous 20-year limitation period that applied to an action on a judgment. Indeed, under s. 16(1) of the new Act, no limitation period now exists with respect to such actions.

Returning to the controversy surrounding s. 22, many groups are lobbying for an amendment to the provision. At the same time, lawyers are analyzing ways to avoid the impact of the inability to contract out of the new Act. In commercial transactions, depending on whether parties want to extend or shorten the statutory time period, different techniques are being employed. But uncertainty in how an Ontario court will react to the various techniques is preventing lawyers from reassuring their clients that the techniques employed are enforceable.



With respect to litigation, the prohibition against contracting out frustrates the ability of parties to a claim or potential claim from entering into tolling agreements so as to delay the running of a limitation period. This prohibition arguably puts pressure on parties to ensure that actions are commenced within the requisite limitation period notwithstanding the claim or potential claim has not been fully investigated.

The new Act is a ticking time bomb for those who could be caught off guard with respect to the shortening of the general limitation period, for those parties in commercial transactions who are forced to choose between commercial reality and the black and

white letter of the law and for those in litigation matters who desire that a matter is fully investigated prior to commencing a claim.

Relief however may soon be in sight for those who have lobbied for amendments to s. 22. It is the understanding of this author that draft amendments are currently under consideration.

TAKING SECURITY IN AIRCRAFT: THE NEW FRONTIER

by Lori Mark and Anna Stewart

Lending on the security of mobile goods such as aircraft presents some specific legal and practical challenges for financiers. The lack of a unified international set of rules governing security in aircraft has been a significant impediment to aircraft financiers and the aviation industry in general.

Canada and the U.S. each currently have in place rules governing security interests in mobile goods such as aircraft. These are contained in personal property security legislation (“PPSA”) in the Canadian common law jurisdictions, the *Civil Code of Quebec* (“CCQ”) and Article 9 of the U.S. *Uniform Commercial Code* (“UCC”). However, these rules are uncertain in some respects and can be complicated to implement. For aircraft which may be located outside Canada or the U.S., creditors wanting to more fully protect their rights are confronted with a variety of security regimes internationally and the additional cost and delay involved in retaining local counsel to ensure that the laws of other applicable jurisdictions are adhered to. As aircraft may move from jurisdiction to jurisdiction, creditors may still not be fully confident that their interest is risk-free.

However, the international community has now been making some progress in creating a unified set of

rules governing security in aircraft. In late 2001, the *Convention on International Interests in Mobile Equipment* (the “**Convention**”) and accompanying *Protocol on Matters Specific to Aircraft Equipment* (the “**Protocol**”) were presented at a diplomatic conference of some 68 nations held in Cape Town, South Africa. The Convention and Protocol were developed by the International Institute for the Unification of Private Law (Unidroit), an independent intergovernmental organization based in Rome, formed to review requirements and methods for harmonizing and modernizing private law between states. The Convention and Protocol are intended to create an international regime governing interests in mobile equipment such as aircraft. This includes the establishment of one central international registry for security interests, which will give notice of security interests internationally and preserve priorities of creditors. The Convention contains general rules applicable to international interests in mobile equipment, while the accompanying Protocol contains specific provisions relating to aircraft. An Irish company named Aviareto, based in Shannon, has been selected, as part of an international tendering process, to create the international registry and act as registrar once the new rules are in force.



Although the Convention and Protocol have been well received internationally, the creation of the new regime is still in its preliminary stages and does not yet have the force of law at either the international or national level. Twenty-eight nations have now signed the Convention/Protocol, including the United States and, on March 31, 2004, Canada.

Consistent with the rules of international law, the Convention and Protocol must be not only signed but ratified. Internationally, although the Convention formally obtained the force of law in 2004 upon ratification by a third signatory nation, the Protocol will not come into force until three months following ratification by an eighth signatory nation. Currently, six nations, including the United States but not including Canada, have ratified the Protocol, leaving the international community waiting for two additional nations to take this step.

In order to have legal effect in Canada, the Convention and Protocol must also be implemented domestically, both at the federal level and by the provinces and territories. Federally, the *International Interests in Mobile Equipment Act* received royal assent on February 24, 2005, but has not yet been proclaimed into force. This statute implements the Convention and accompanying Protocol and amends the *Bank Act* and certain insolvency-related statutes including the *Bankruptcy and Insolvency Act*, *Companies' Creditors Arrangement Act* and the *Winding-up and Restructuring Act*. To date, Ontario and Nova Scotia are alone among the provinces and territories in having drafted implementing legislation, although such legislation is not yet in force.

EQUITABLE SUBORDINATION AN AMERICAN CONCEPT

by Lori Mark and Zev Zlotnick

The doctrine of equitable subordination is of special relevance to creditors facing a priority battle with a prior creditor who has engaged in some type of inequitable conduct to their detriment.

As questions surrounding the coming into force of the Convention and Protocol are resolved, other key questions regarding national and international implementation are likely to arise. One consideration is the operation of the register and how it will interact with local registries such as the Ontario Personal Property Security Registry. Will registration continue to be made through local registry systems, linked to the international registry and then deemed to have the effect of registering the interest for international purposes? Alternatively, will provincial and territorial governments require registration in the international register, and deem the international registration to have the effect of superseding the provincial or territorial registration? Similarly, how will Canada deal with existing security interests in aircraft and will the principle of grandfathering apply?

Although the creation of the new system is still in its early stages, it is anticipated that once effective internationally it will reduce uncertainty, risk, and credit costs. This will bring about fundamental positive changes for aircraft financing in Canada and benefit not only the airline industry but also the broader economy. Under the new system, aircraft financiers and lending institutions can expect to approach financing transactions with greater ease and confidence that their interests are more fully protected, not only within Canadian borders, but also in other jurisdictions where the aircraft in which they hold security may venture.

Principles of equitable subordination were embraced long ago by American courts and are now incorporated in section 510(c) of the U.S. *Bankruptcy Code*, which states that:



510(c) *Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may:*

- (1) *under principles of equitable subordination, subordinate for the purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or*
- (2) *order that any lien securing such subordinated claim be transferred to the estate.*

American bankruptcy courts may rely on equitable subordination to adjust creditor priorities so that a prior-ranking creditor is subordinated to other creditors where it has behaved inequitably or fraudulently, especially where that creditor has a degree of control over the debtor. U.S. courts have established three conditions which must be satisfied before a creditor's priority will be altered: (1) the offending creditor must have engaged in some type of inequitable conduct (such as fraud, illegality or breach of fiduciary duty); (2) the misconduct must have resulted in injury to other creditors or unjustly improved the position of the creditor; and (3) subordination must be consistent with and not otherwise violate the principles of bankruptcy law (*Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F. 2d 692 (5th Cir. 1977)).

Though well established under American law, equitable subordination has yet to receive legislative or judicial sanction in Canada. There is no equivalent in Canadian legislation, including Canada's *Bankruptcy and Insolvency Act* ("BIA"), to section 510(c) of the U.S. *Bankruptcy Code*, although it should be noted that section 183 of the BIA invests provincial and territorial superior courts "with such jurisdiction at law *and in equity* as will enable them to exercise original, auxiliary and ancillary jurisdiction in bankruptcy". Similarly the doctrine has had no clear acceptance by Canadian courts, which in general have either rejected it outright, refrained from commenting on its applicability, or left the door open for future adoption.

For example, in *AEVO Co. v. D & A Macleod* (1991), 4 O.R. (3d) 368, the court rejected the doctrine of equitable subordination. In this case, the debtor company granted a general security agreement to its landlord. The debtor was subsequently declared bankrupt and the trustee in bankruptcy asked the court

to apply the doctrine of equitable subordination to subordinate the landlord's claim. The trustee took the position that: (1) the landlord had effectively controlled the debtor company's financing by, among other things, setting up a separate bank account in its own name into which all of the debtor's receivables were deposited, and issuing all of its cheques; (2) the landlord had allowed and encouraged the debtor to continue incurring debts which the landlord knew or should have known would not be paid, in order to maximize the landlord's own recovery; and (3) the landlord's claim should be subordinated as its conduct had prejudiced the rights of the other creditors. The court found that the facts in this case did not satisfy the above three pre-conditions established by American courts, but that in any event the doctrine of equitable subordination had no application in Canadian law. The court stated that the BIA itself sets out a specific scheme for identification of claims and distribution of estates, and to incorporate the doctrine of equitable subordination into the BIA would create chaos and lead to challenges of security agreements based on the conduct of the secured creditor. In the court's words, "the legislation itself provides a speedy method in which issues are to be resolved and litigation avoided".

In *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*, (1992), 16 C.B.R. (3d) 154 (S.C.C.), the Supreme Court of Canada stated that even if equitable subordination were available under Canadian law, a question which it left open for another day, it did not find that the three American pre-conditions for its application had been satisfied.

The court in *Unisource Canada Inc. v. Hongkong Bank of Canada*, (1998), 43 B.L.R. (2d) 226 (Ont. Court of Justice (General Division)) similarly refrained from commenting on the applicability of the doctrine in Canada. In this case, the shareholders of the debtor company converted their equity investment into shareholder loans secured by a second-ranking general security agreement, by notionally paying out the stated capital to shareholders and then lending the money back to the business on a secured basis. After the debtor company filed an assignment in bankruptcy, the first-ranking bank was paid in full, and the contest for the remaining assets was between the shareholders as first-ranking secured creditor and the company's major supplier as second-ranking secured creditor. The court rejected the argument that the doctrine of equitable subordination should be applied to subordinate the prior



secured claim of the shareholders to the supplier's secured claim. It held that even if the doctrine of equitable subordination were a part of Ontario law, it was not available on the facts of this case as the defendant had not acted inequitably. The court made other comments which shed some light on its view of the application of equitable subordination in Canada. It stated that the BIA and various provincial statutes provide a statutory scheme for distribution of a bankrupt's estate that enshrines most of the "equitable principles" that form the basis for many "equitable subordination" decisions in American cases. The court referred to, among other things, section 183 of the BIA in stating that Canadian bankruptcy courts clearly have equitable jurisdiction, but, other than in cases of fraud or misrepresentation, should be cautious about departing from the statutory scheme for distribution and relief.

Lastly, the recent lower court decision in *C.C. Petroleum Ltd. v. Allen*, [2002] O.J. No. 2203 (S.C.) (QL), (S.C.J. (Commercial), June 5, 2002) caused a stir in the lending community as a signal that the doctrine of equitable subordination was now available under Canadian law. The lower court decision applied the doctrine of equitable subordination in subordinating the secured claim of one of the defendants to the claim of the plaintiffs.

The court held that the defendants had committed fraud, acquired an unfair advantage and injured the plaintiff, and all the prerequisites had been satisfied for application of the doctrine of equitable subordination. However, the appeal court (*C. C. Petroleum Ltd. v. Allen*, [2003] O.J. No. 3726 (QL) (C. A., September 26, 2003)) overturned that portion of the decision, stating that it is an open question whether the trial judge had jurisdiction to apply the doctrine, that the law was uncertain and that certain facts rendered the finding of equitable subordination unnecessary.

Given the lack of unequivocal judicial precedent and clear statutory support in Canada, creditors should be hesitant about relying on the doctrine of equitable subordination in Canada with the same confidence as they might under American law. However it should be noted that in certain circumstances the corporate oppression remedy, to the extent it is available to creditors, may be a viable option where equitable subordination is unavailable.

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