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SECURED OR POSTPONED: WHERE DOES THE SECURED LENDER WHO SHARES IN THE PROFITS STAND?

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ON APRIL 4, 2011, THE HONOURABLE BENOÎT MORIN, SPEAKING FOR THE COURT OF APPEAL, WITH JUSTICES MICHEL ROBERT AND JACQUES A. LÉGER CONCURRING, ISSUED A JUDGMENT CONFIRMING THE DECISION OF THE SUPERIOR COURT RENDERED ON APRIL 22, 2009 BY THE HONOURABLE JEAN-YVES LALONDE. THE CASE AROSE OUT OF THE BANKRUPTCY OF STONEHAVEN COUNTRY CLUB RESORT & SPA L.P. ("STONEHAVEN")[1]; THE COURT HAD TO RULE ON THE VALIDITY OF INVESTISSEMENT QUÉBEC'S CLAIM AGAINST THE BANKRUPT COMPANY. MORE SPECIFICALLY, THE COURT OF APPEAL REVIEWED THE SCOPE OF SECTION 139 OF THE *BANKRUPTCY AND INSOLVENCY ACT* (HEREINAFTER THE "BIA"), WHICH PROVIDES THAT IN THE EVENT OF THE BANKRUPTCY OF A BORROWER, THE CLAIM OF A LENDER WHO HAS CONTRACTED TO RECEIVE A RATE OF INTEREST VARYING WITH THE PROFITS, OR A SHARE OF THE PROFITS, ARISING FROM CARRYING ON THE TRADE OR BUSINESS CANNOT BE RECOVERED UNTIL THE CLAIMS OF ALL OTHER CREDITORS HAVE BEEN SATISFIED. THE COURT HAD TO DETERMINE WHETHER THIS RULE APPLIED TO INVESTISSEMENT QUÉBEC, WHOSE HYPOTHECARY LOAN CONTAINED A CLAUSE WHEREBY A PREMIUM WAS PAYABLE TO IT ACCORDING TO THE PROFITS OF THE BUSINESS.

BACKGROUND

On January 20, 2005, Investissement Québec granted to Stonehaven a $2,500,000 loan secured by a hypothec. The contract contained clauses dealing with the calculation of the rate of interest on the loan and information on the hypothecs to be granted by Stonehaven. The contract also contained clauses setting out the terms of an annual premium to be paid by Stonehaven. This premium amounted to 4.7619% of the annual profits of the business.

In July 2006, Stonehaven, no longer able to honour its contractual obligations, was left with no choice but to file a notice of intention to make a proposal under section 50.4 (1) of the BIA. The proposal was eventually accepted by the creditors and sanctioned by the Superior Court, but never implemented.

In January 2007, Investissement Québec served on Stoneham a prior notice of its intention to exercise its hypothecary right to have the hypothecated property sold under judicial authority. Four months later, a motion to institute proceedings was served for the purpose of exercising this remedy. The motion was allowed by the Superior Court in October 2007. In February 2008, Stonehaven made an assignment of its property to the previously appointed trustee. The trustee sent to Investissement Québec a notice of stay of proceedings under section 69.3 of the BIA and a notice under section 128 of the BIA requiring it to file a proof of the security it held on Stoneham's property.

[1] *Stonehaven Country Club Centre de villégiature & spa l.p. (Syndic de)*, 2011 QCCA 718.

The appellants were the main unsecured creditors of Stonehaven. In May 2008, they had asked the trustee to dismiss Investissement Québec's claim as a secured creditor and treat the claim as a postponed claim as per section 139 of the BIA. Investissement Québec's claim would then be paid after their own [translation] "in which case they would be paid an otherwise unhoped-for dividend". The trustee refused and the appellants filed a motion under section 38 (1) of the BIA to be authorized to act in place of the trustee. This motion was allowed on May 22, 2008 and the trustee assigned to the appellants all his rights and interests with respect to Investissement Québec's proof of claim.

The appellants then dismissed Investissement Québec's claim and relegated it to the very last rank of unsecured claims under section 139 of the BIA, alleging that due to the profit-sharing clause contained in the loan agreement, Investissement Québec's claim should be postponed.

Investissement Québec challenged this decision and that led to the decision of the Superior Court and the appeal before the Court of Appeal.

THE DECISION OF THE SUPERIOR COURT

Mr. Justice Lalonde cancelled the notice of dismissal of Investissement Québec's claim and confirmed its status as a secured creditor. He considered that, in light of the case law, the purpose of section 139 of the BIA was to [translation] "prevent a passive or silent partner from participating in the distribution of dividends by a trustee in bankruptcy on account of advances made in consideration for a percentage of the profits." In the present case, the amounts lent by Investissement Québec were recorded in the financial statements of Stonehaven as a loan and the security interest was duly published. He, therefore, concluded that [translation] "the true, main and dominant substance of this agreement was to establish a debtor-creditor relationship, and the premium based on a percentage of profits was only an accessory to the agreement." Lastly, the Court concluded that it would be possible to split the claim into the amounts owed under the loan contract and the amount attributable to the premium provided for under the same contract, this issue being only theoretical however since, in fact, Stonehaven had made no profit.

> [Translation] [38] "To characterize the advances made by the lender, the true substance of the contract is the criterion which must guide the Court in its assessment of the agreement entered into between the bankrupt and the lender."[2]

ISSUES IN DISPUTE

The Court of Appeal examined the following two issues:

1. Did the trial judge err in concluding that section 139 of the BIA does not apply to a contract secured by a hypothec on the property of the borrower?
2. Did the trial judge err in concluding that he could split Investissement Québec's proof of claim to extract the amount attributable to the premium required by Investissement Québec as provided for under the loan agreement?

ANALYSIS

1. APPLICATION OF SECTION 139 OF THE BIA

The Court of Appeal, in agreement with the trial judge, concluded that the loan agreement entered into between the parties was not one to which section 139 applied. That section reads as follows:

> **139.** Where a lender advances money to a borrower engaged or about to engage in trade or business under a contract with the borrower that the lender shall receive a rate of interest varying with the profits or shall receive a share of the profits arising from carrying on the trade or business, and the borrower subsequently becomes bankrupt, the lender of the money is not entitled to recover anything in respect of the loan until the claims of all other creditors of the borrower have been satisfied.

In order to determine the application of this section to the present case, the Court of Appeal reviewed the Supreme Court of Canada's ruling in *Sukloff* v. *A.H. Rushforth & Co* (hereinafter *"Sukloff"*)[3], in 1964, in which it had discussed the interpretation of section 98 of the BIA (the equivalent of the current section 139 of the BIA). That decision established, based on English law principles, that when a loan is secured section 139 of the BIA is not applicable, even if the loan contract contains a profit-sharing clause. Since that decision, many authors have adopted the same reasoning.

> "[46] [Translation] ... I am of the view that (...) the secured debt nature of the loan made by Investissement Québec to Stonehaven does not allow the appellants to rely on section 139 of the Act to support their assertion."[4]

In the case under review, Investissement Québec acted as a hypothecary lender and therefore, had a secured claim. Even if both aspects were present in the loan agreement, that is, the repayment of the loan itself and the payment of a premium based on the profits of the business, the Court was of the view that it was truly a debtor-creditor situation. The true essence of the contract was of the nature of a loan, not a profit-sharing arrangement following a loan in the course of a business partnership. The profit-sharing clause in favour of Investissement Québec was only an accessory to the loan contract and section 139 of the BIA did not apply to it.

2. THE POSSIBILITY OF SPLITTING THE PROOF OF CLAIM

The trial judge concluded that it was possible to split Investissement Québec's claim into the amount attributable to the premium and that attributable to the repayment of the loan. The Court of Appeal reversed the trial judge on this issue on the ground that he could not rely on the *Sukloff* case to split the claim since the facts of that case were different on this point. The Court also stated that the issue was theoretical since by deciding only the first issue it was possible to see that section 139 of the BIA did not apply in this case.

DISCUSSION

This is yet another case in which the courts have been called upon to rule on the interpretation of section 139 of the BIA, formerly section 98. Among the previous cases, the Superior Court has decided that section 139 of the BIA is not applicable to a creditor who is a related party if the loan was made in the ordinary course of business and it was not demonstrated that profit-sharing was provided for.[5] It was also decided in another case currently in appeal[6] that the main shareholder of a company who advances funds to the company is not a regular lender and that his claim must be postponed under section 139 of the BIA. Deciding otherwise would create an undue benefit for silent partners, which is precisely what section 139 of the BIA seeks to prevent.

Thus, the courts interpret section 139 of the BIA according to the principle whereby the claim of a creditor who is a party to the business of the debtor must be collocated after those of all the other creditors, while the claim of a *bona fide* lender must not be postponed.

The *Stonehaven* decision confirms this approach and reaffirms the principle established by the Supreme Court of Canada in the *Sukloff* case, according to which section 139 of the BIA should not apply to a true secured loan.

It is therefore essential to determine the true nature of the contract[7] in order to ascertain whether it is a loan or a business partnership. The Court established that it is possible for a loan agreement to be secured by a hypothec in addition to containing a premium based on profits without section 139 of the BIA being applicable. Indeed, the purpose of this section is to prevent a business partner who invested in the business in exchange for a share of the profits from being repaid before the other creditors, not to relegate a lender who has a secured claim to the last rank, after all the other creditors of the business.

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[2] *Stonehaven Country Club Centre de villégiature & spa l.p. (Syndic de)*, 2009 QCCS 1685, para [38].

[3] [1964] S.C.R. 459.

[4] Op cit Note 1, para [46].

[5] *Club de voyage Aventure inc. (Syndic de)*, J.E. 2000-2264, AZ-50080717.

[6] *Installations Doorcorp inc. (Syndic de)* 2010 QCCS 3618, AZ-50664381 (inscription in appeal, 2010-06-21 (C.A.)).

[7] Also see the judgment of the Supreme Court of Canada in the case of *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*, [1992] 16 C.B.R. (3d) (S.C.C.).

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