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THE DOORCORP CASE: THE COURT OF APPEAL RENDERS YET ANOTHER DECISION ON SECTION 139 BIA AND THE POSTPONEMENT OF CLAIMS

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LAST JUNE WE DISCUSSED THE COURT OF APPEAL DECISION IN *STONEHAVEN COUNTRY CLUB*[1], WHICH DEALT WITH THE APPLICATION OF SECTION 139 BIA TO A CLAIM BY INVESTISSEMENT QUÉBEC.[2] THE COURT OF APPEAL HAS RULED ON THE SCOPE OF THIS SECTION ONCE AGAIN.

On April 17, 2012, the Honourable Marc Beauregard, writing for the Court of Appeal with Justices Marie-France Bich and Jean Bouchard concurring, quashed in part the Superior Court decision rendered by the Honourable Pierre Journet dated June 11, 2010. This case involved the bankruptcy of Doorcorp Installations Inc. **("Doorcorp")**. In it, the Court of Appeal examined the characterization of advances of funds by Ballylickey Investments **("Ballylickey")** to Doorcorp. Given that Ballylickey is the parent company and sole shareholder of Doorcorp, did the advances constitute claims falling under section 139 of the *Bankruptcy and Insolvency Act* **("BIA")**, i.e. postponed claims, or were they claims that should be ranked with those of the unsecured creditors?

THE CONTEXT

In 2004, Ballylickey acquired the shares of Doorcorp, which manufactures doors and doorframes, for $2.4 M.

Between February 2006 and June 2007, Ballylickey injected funds into Doorcorp four times, for a total of $1,762,500. Following Doorcorp's notice of intention to file a proposal dated November 27, 2007, Ballylickey submitted a claim as an unsecured creditor for an amount of $1,502,906.39.

On October 9, 2008, the trustee KPMG rejected Ballylickey's proof of claim on the ground that the money paid to Doorcorp was in fact [Translation] "an advance of capital, not a claim repayable according to fixed and predetermined terms"[3]. Relying on section 139 BIA, the trustee was of the opinion that the advances made by Ballylickey to Doorcorp could not be recovered before the claims of all the other unsecured creditors were paid.

Ballylickey appealed this decision before the Superior Court to have its status as an unsecured creditor recognized with respect to the proof of claim for $1,502,906.39. The Superior Court dismissed Ballylickey's claim in part, and Ballylickey appealed this decision to the Court of Appeal.

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

[2] See the Bulletin "Secured or postponed: Where does the secured lender who shares in the profits stand? *In Fact and in Law* – Lavery, July 2011.

[3] *Installations Doorcorp inc./Doorcorp Installations Inc. (Syndic d')*, 2012 QCCA 702, parag. [14].

THE SUPERIOR COURT DECISION

The Honourable Pierre Journet divided the $1,502,906.39 claim into two parts: with respect to the amount of $762,500 paid on February 26, 2006, the Court held that it constituted an investment and that, accordingly, it should not be allowed in the proof of claim. The Superior Court decision in this regard was not appealed. With respect to the balance of the claim, namely an amount of $740,406.39, the Court held that this portion of the claim was an advance and characterized it as a postponed claim within the meaning of section 139 BIA, i.e. a claim which can only be recovered after all proven claims have been fully satisfied. Ballylickey's appeal involves this point.

Justice Journet relied on the criteria set forth in *Laronge Realty* v. *Golconda Invt. Ltd.*[4] to determine whether or not the amount in dispute constituted a postponed claim. Noting that the advances stemmed from a verbal contract, which nonetheless appeared in Doorcorp's financial statements as a "loan", Justice Journet wrote the following:

> [Translation] "[63] An attempt is now being made to participate in the distribution of a dividend of (sic) by the trustee on the ground that the criteria relating to advances of funds do not fully meet those found in *Laronge Realty*.
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> [64] The Court does not believe that it must follow this legal approach of the applicant creditor. It prefers to abide by the spirit of the law and section 139 BIA, the purpose of which is to prevent a creditor from participating in a dividend on account of advances made in consideration of a repayment out of future profits.
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> [65] The fact that Ballylickey is the sole shareholder of Doorcorp weighs in favour of a broad rather than a narrow interpretation of section 139 BIA since, in the end, the Court cannot allow the creditor's application, which would give it an undue advantage as a result of the full application of *Laronge*."[5]

COURT OF APPEAL DECISION

The Court of Appeal ruled on the following question:

> Did the judge in first instance err in holding that section 139 BIA applied to the $740,406.39 claim?

In other words, as the Court of Appeal put it, should the sums of money paid by Ballylickey to Doorcorp [Translation] "be considered interest-free loans, in which case Ballylickey is an unsecured creditor with the same ranking as the other unsecured creditors, or are they capital contributions, or loans entitling the lender to variable interest according to Doorcorp's profits, in which case, according to section 139 BIA, Ballylickey could, given Doorcorp's bankruptcy, recover its money only once the claims of all Doorcorp's other creditors have been paid?"[6]

Justice Bouchard quashed the Superior Court decision, holding that this claim was not subject to section 139 BIA Accordingly, he ascribed to Ballylickey the status of unsecured creditor for this amount, not that of a postponed creditor.

Section 139 BIA 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 *Laronge Realty* v. *Golconda Invt. Ltd.*[7], the British Columbia Court of Appeal examined the issue of advances of funds made by related corporations, and the status of creditors in the event of an ensuing bankruptcy. The Court set out criteria allowing it to be determined whether advances of funds should be considered loans or, on the contrary, an investment.

[4] 1986 Carswell BC 496, 63 C.B.R. (N.S.) 74.

[5] *Installations Doorcorp inc./Doorcorp Installations Inc. (Syndic d')*, 2010 QCCS 3618 (CanLII), par. [63] to [65].

[6] *Op. cit.*, footnote 1, parag. [8].

[7] *Op. cit.*, footnote 2.

In the present case, the Court of Appeal confirmed the criteria set out in *Laronge Realty* v. *Golconda Invt. Ltd.* but held that the Superior Court did not apply them correctly. Justice Beauregard was of the view that, although [Translation] "no term, interest rate or repayment terms were provided" [8], that was not sufficient to conclude that the advances were in fact injections of funds. To the extent that the parties had explicitly provided that the loans were interest-free, the Court of Appeal held that one could not say that there was an interest rate that varied according to the profits. In addition, considering in this case the expectation of profits only as an indirect effect of the loan, the Court held that section 139 BIA could not apply. According to Justice Beauregard, the fact that it was in Ballylickey's interest to be repaid if Doorcorp realized a profit was not enough to conclude that section 139 BIA applied.

> [Translation] "[33] It was certainly in Ballylickey's interest to advance these funds in order to recover or save the $2.4 M it invested to acquire Doorcorp's shares and maybe even to also obtain a return on its investment, but such an expectation is not the criterion used by the legislator in section 139 BIA. Also, it is not appropriate to extend the meaning of section 139 and to say that this is the equivalent of sharing in the company's profits since the loan could eventually have the indirect effect of allowing the payment of a dividend to the shareholder or increasing the value of the company's capital stock.
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> [34] The effect of the Superior Court judgement is also to deprive the sole shareholder of the right to replenish its company's working capital in the hope of preventing its bankruptcy without the risk of losing the amount it is lending. In short, the mere fact that, following the loan, the company could eventually make a profit and pay it a dividend or even increase the value of its capital would provoke the application of section 139. Although the legislator could have adopted a provision to this effect, it did not do so." [9]

Justice Beauregard, while concurring with Justice Bouchard, added a comment to his reasons, affirming that section 139 BIA should receive a strict application, as it is a prohibitive provision:

> "[54] This is a prohibitive provision which should certainly be fully applied under the circumstance described in it, but we would be wrong to apply it when that circumstance does not exist. Analogy is not a good tool for interpreting prohibitive provisions.
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> [...]
>
> [57] The fact that the loans were only repayable if the company could eventually pay them back does not mean that they were variable rate loans. There is a difference between the term of a loan and the interest rate applied to it." [10]

According to Justice Beauregard, the fact that there was no express or implied agreement in this case that Ballylickey would receive interest depending on the profits generated by Doorcorp meant that section 139 BIA could not apply.

COMMENTS

In this case, the Court of Appeal decided to give great weight to the entries in the debtor's books and the testimony of the accountant for both companies, and in so doing it chose to interpret section 139 BIA narrowly. By limiting the scope of this provision, the Court of Appeal set aside the Superior Court's reasoning that, where there is a creditor who is the sole shareholder of a bankrupt company, section 139 BIA should be interpreted broadly [11]. In our opinion, this case could open the door to unjustified advantages for silent partners.

As the Superior Court mentioned, the purpose of section 139 BIA is [Translation] "to prevent a creditor from participating in a dividend as a result of advances made in consideration of a repayment out of future profits" [12]. Silent partners are covered by this provision and should not rank with unsecured creditors, given the special position they hold within the company, unless they lent money under a contract in due form. In this case, Ballylickey was Doorcorp's sole shareholder, and therefore it and the bankrupt company were "related persons" pursuant to section 4 BIA In our view, the perspective of a return on investment for the silent partner should be enough to conclude that there is a postponed claim, unless the existence of a loan with normal commercial terms can be clearly established.

[8] *Op. cit.*, footnote 3, par. [61].

[9] *Op. cit.*, footnote 1, parag. [33] and [34].

[10] *Op. cit.*, footnote 1, parag. [54] and [57].

[11] *Op. cit.*, footnote 3, parag. [65].

[12] *Op. cit.*, footnote 3, parag. [64].

In *Stonehaven*, a case we commented on in June 2011, the Court of Appeal stressed the importance of characterizing the true nature of a contract to determine whether the parties had entered into a loan or a business partnership. Strangely, in *Doorcorp*, the Court of Appeal does not mention its decision in *Stonehaven*. We believe it would have been appropriate to reconcile these two decisions, which seem to be based on very different approaches—one seeking the true nature of the relationship beyond the letter of the law and the other applying section 139 BIA to the letter.

The distinction established by section 139 BIA between creditors with a close relationship to the bankrupt and "true lenders" which *Stonehaven* appeared to support seems, following *Doorcorp*, to have been set aside in favour of a narrow interpretation of this provision.

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