

CITATION: Tucker v. Acro Inventory (UK) Limited, 2011 ONSC 4223
COURT FILE NO.: 09-8456-00CL
DATE: 20110818

SUPERIOR COURT OF JUSTICE – ONTARIO

(COMMERCIAL LIST)

RE: IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*,
R.S.C. 1985, c. C-36, AS AMENDED

AND IN THE MATTER OF JAMES ROBERT TUCKER, RICHARD HEIS
AND ALLAN WATSON GRAHAM OF KPMG LLP, AS JOINT
ADMINISTRATORS, Applicants

AND IN THE MATTER OF AERO INVENTORY (UK) LIMITED and AERO
INVENTORY PLC, Respondents

APPLICATION UNDER SECTION 46 AND FOLLOWING OF THE
COMPANIES' CREDITORS ARRANGEMENT ACT, R.S.C. 1985, c. C-36, AS
AMENDED

BEFORE: MORAWETZ J.

COUNSEL: Orestes Pasparakis, Evan Cobb and Vasuda Sinha, for the Trustee

Sean F. Dunphy, Alexander D. Rose and Kathryn Esaw, for Air Canada

ENDORSEMENT

[1] KPMG Inc., as Trustee in Bankruptcy (the "Trustee") for Aero Inventory (UK) Limited and Acro Inventory plc (together, "Acro") brings this motion to have certain transactions (the "October Transactions") entered into between Acro and Air Canada declared void pursuant to s. 95 of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, ("*BIA*"). The Trustee seeks the return of value in the amount of U.S. \$75 million from Air Canada (the "Preference Proceeds").

[2] A threshold issue has been identified. The Trustee takes the position that the Preference Proceeds, once recovered, would be subject to the rights of Acro's secured creditors. Air Canada takes the position that any proceeds resulting from this preference motion should only benefit Acro's unsecured creditors.

[3] Therefore, at this point, the central issue is a question of law: are the proceeds of a preference action under s. 95 of the *BIA* subject to the rights of secured creditors?

- Page 2 -

[4] In addition to the direction sought with respect to the priority of the Preference Proceeds, Air Canada also seeks an order regularizing the proceedings under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, ("CCAA"), the parallel proceedings under the *BIA* and the preference motion.

BACKGROUND INFORMATION

[5] In its factum, Air Canada has provided an account of the events leading up to the October Transactions. In view of the threshold question of law, in my view, it is premature to focus on the facts in respect of the October Transactions. A brief overview of the background is, however, helpful, to put matters into context.

[6] On November 11, 2009, Administration proceedings in respect of Aero were commenced in the High Court of Justice of England and Wales (Chancery Division, Companies Court) (the "Foreign Proceedings"). Messrs. Tucker, Heis and Graham of KPMG LLP were appointed as joint administrators (the "Administrators") of Aero.

[7] On the same day, this court recognized the appointment of the Administrators as foreign representatives of Aero (the "Foreign Representatives") under Part IV of the *CCAA*.

[8] Aero reported that its secured creditors would face a shortfall of approximately £150 million, while its unsecured creditors, who are owed approximately £60 million, would receive virtually nothing at all.

[9] Following the November 11, 2009 filings, the Foreign Representatives met with Air Canada and discussed, *inter alia*, the October Transactions. From the Foreign Representatives' standpoint, a concern arose that the October Transactions might constitute an unlawful preference.

[10] The October Transactions arose out of a relationship between Air Canada and Aero in respect of maintenance required for Air Canada's aircraft. In December 2008 Air Canada and Aero executed an agreement (the "Line Maintenance Agreement") under which Aero became Air Canada's exclusive supplier for practically all of its Category 3 Inventory used for line maintenance.

[11] In early 2009, Aero and Air Canada entered into an agreement (the "January Purchase Agreement") under which Aero sold to Air Canada a pool of Category 3 Inventory. Over the course of the year, Aero was expected to purchase parts from this pool of inventory.

[12] In return, Air Canada provided Aero with nine U.S. \$10 million principal Bills of Exchange (#1 – 9) and one similar Bill of Exchange (#10) for approximately U.S. \$10.7 million (collectively, the "Bills of Exchange"). Each of the Bills of Exchange was payable to Aero and drawn on Air Canada. Air Canada contends that with the exception of transfers of the Bills of Exchange to Deutsche Forfait (which never, in fact, occurred), the January Purchase Agreement required Air Canada's consent to any transfer of the Bills of Exchange.

[13] Air Canada contends that Aero ultimately failed to comply with the most significant provisions of the January Purchase Agreement. Ultimately, Aero and Air Canada reached an

- Page 3 -

agreement under which certain Bills of Exchange were delivered back by Aero to Air Canada. It is this series of transactions as between Aero and Air Canada that the Trustee refers to as the October Transactions.

[14] In January 2010, the Foreign Representatives brought a motion to assign the Aero companies into bankruptcy expressly "for the purpose of pursuing a preference action under s. 95(1) or 96(1) of the *BIA*. On January 22, 2010, the court authorized the Administrators to assign Aero into bankruptcy and temporarily lifted the stay for that purpose (the January 2010 "Order").

[15] In seeking the January 22, 2010 Order, the Administrators advised the court that they wished to assign Aero into bankruptcy to preserve the right to pursue any reviewable preferences that may have taken place during the statutory review period prescribed by the *BIA*. The Administrators further advised that their security searches had revealed two secured creditors, Lloyds (asserting a general security interest in Aero's assets) and Air Canada.

[16] On February 4, 2010, the Trustee reported that although no claims process had been conducted, all creditors had been advised of the Administrators' view that the secured creditors would suffer a significant shortfall and that there would be no funds available for distribution to unsecured creditors. The Trustee further reported its expectation that the secured creditors' security would extend to any funds generated from a preference claim under ss. 95 or 96 of the *BIA*.

[17] The Trustee also reported that, in light of the expectation that there would be no recoveries to unsecured creditors, it saw no value in incurring the expense associated with the discharge of its statutory obligations under the *BIA*.

[18] On February 4, 2010, the Trustee filed a motion seeking to dispense with certain obligations of the Trustee under the *BIA*. The court granted the order sought by the Trustee (the "February 2010 Order"). Air Canada did not oppose the relief sought. The court issued the February 2010 Order in the *CCAA* proceedings extending the time period for the Trustee to perform its statutory obligations under the *BIA* (including convening a meeting of creditors and holding a vote of the unsecured creditors) until further order. The February 2010 Order further authorized the Administrators to provide direction to, and supervise the Trustee in pursuing the contemplated preference motion, subject to the review of the court.

[19] On April 27, 2010, the Trustee brought a motion in the *CCAA* proceedings seeking a declaration that the October Transactions between Air Canada and Aero constituted a preference within the meaning of s. 95(1) of the *BIA*.

[20] On June 30, 2010, the Trustee filed a report which included opinions from independent counsel on the validity and enforceability of the security held by a syndicate of secured lenders (the "Lenders") over Aero's assets.

[21] Aero financed its business with the U.S. \$500 million revolving facility which it obtained from the Lenders. The Lenders hold:

- Page 4 -

- (a) a general security interest and fixed mortgage over all the personal property of Aero in Canada, which has been duly registered; and
- (b) a deed of Hypothec also duly registered in the Province of Quebec.

THE ISSUES

[22] Three issues need to be determined on this threshold motion:

- (a) Whether secured creditors are entitled to assert priority over the proceeds of a preference action. Put another way, can the Trustee pursue the preference action solely on behalf of, and for the benefit of, a secured creditor?
- (b) Is the preference motion properly brought within the *CCAA* proceedings, or should it be reconstituted in the bankruptcy proceedings?
- (c) Should the February 2010 Order be varied to provide that the Trustee has to comply with certain obligations under the *BIA*?

[23] As the Trustee points out in its factum, on several occasions, Canadian courts have had to consider whether a secured creditor has the right to assert its priority claim over the proceeds of a preference action. The Trustee acknowledges the body of jurisprudence appears unclear, inconsistent and conflicting.

[24] It is the Trustee's position that jurisprudence and policy considerations underlying the *BIA* lead to the conclusion that the Preference Proceeds should be paid over to the Lenders by the Trustee.

[25] Air Canada, not surprisingly, takes a different position. Air Canada does not contest the Trustee's ability to pursue preference claims in the bankruptcy proceedings. However, Air Canada takes the position that the Trustee cannot pursue a preference claim as an advocate for Lloyds or for Lloyd's exclusive benefit.

THE PARTIES' POSITIONS

1. **Are secured creditors entitled to assert priority over the proceeds of a preference action and can the Trustee pursue a preference action solely on behalf of, and for the benefit of, a secured creditor?**

Air Canada's Position

[26] Air Canada takes the position that a trustee cannot pursue a preference action where the proceeds would accrue to the sole benefit of a secured creditor as to do so is inconsistent with the jurisprudence holding that fraudulent preferences that do not benefit unsecured creditors cannot be pursued. Instead, the right to pursue a fraudulent preference action is a statutory right of the trustee only, and where appropriate to pursue, such preferences are only void as against the trustee, such that the recovered property accrues to the benefit of the general body of unsecured

creditors. Finally, Air Canada submits that the proposed preference action is inconsistent with the role of a trustee.

The purpose of a preference action

[27] Air Canada submits that the purpose of a preference action is to allow for the equal distribution of the debtor's assets among the general body of creditors such that a trustee cannot pursue a preference action for the sole benefit of a secured creditor.

[28] Further, the purpose of s. 95 of the *BIA* is to ensure that the debtor's money is divisible equally among unsecured creditors, subject to the priorities in s. 136 of the *BIA*. In support of this proposition, counsel to Air Canada cites the Supreme Court of Canada in *Hudson v. Benallack*, [1976] 2 S.C.R. 168 at p. 175, where it is noted that the purpose of preference actions is to put all creditors on an equal footing.

[29] Counsel further submits that s. 95 of the *BIA* permits a trustee to challenge the debtor's transactions occurring on the eve of bankruptcy, as such transactions reduce the money available for distribution to creditors and presumably fail to treat all of the creditors equally. Conversely, where there would be no benefit to unsecured creditors from the pursuit of a preference action, the Trustee may not undertake a preference action.

[30] In this case, the Trustee's position is that the proceeds of the preference action accrue to the benefit of the secured creditor. Counsel to Air Canada submits that this would not constitute a benefit to the general body of creditors such that this action cannot be pursued. Instead, secured creditors' rights are to be exercised outside of bankruptcy as a function of their security agreement and provincial law: *BIA*, ss. 69.3, 70(1), 136(1) and 141.

[31] Air Canada takes the position that the jurisprudence is replete with examples of the courts declining to allow a trustee to pursue a preference action where the proceeds would accrue to the sole benefit of secured creditors.

[32] Air Canada submits that in *Ex parte Cooper* (1875), L.R. 10 Ch. App 510 (Div. Ct.) at p. 511-512, the court found that the trustee ought not to pursue a preference action for the benefit of a single creditor. Instead, preference actions are to be pursued for the benefit of all creditors. In that case, a creditor alleged that he had given the debtor an advance of £2000, secured by a consignment of the debtor's shipment of currants. However, once the shipment arrived, the debtor pledged the bills of lading for that shipment to a subsequent creditor, as security for advances made by that person. The Registrar declined to order the trustee to account to the estate for the value of the currants or take the necessary steps for their recovery, but did order that the first creditor was at liberty to use the trustee's name in any proceeding against the subsequent creditor or the debtor to enforce the delivery of the currants or payment of the proceeds to him. On appeal, the Divisional Court found that the trustee's name could not be used in a preference action by an encumbrancer, unless the secured creditor were to give up the claim on the property for the benefit of all creditors. There could be no fraudulent preference where the preference granted concerned property that did not belong to the bankrupt.

- Page 6 -

The right to bring a preference action is a statutory right of the Trustee

[33] Air Canada takes the position that the Trustee's proposed preference action is incompatible with the fact that the right to pursue a preference action is a statutory right provided solely to the Trustee and a secured creditor cannot take advantage of the Trustee's statutory right. Instead, property recovered as a result of the exercise of the Trustee's statutory right is not subject to any security interest.

[34] Counsel to Air Canada referenced *In Re Yagerphone Limited*, [1935] 1 Ch. 392 (Ch.D.) at p. 396, which counsel submits affirms the principle established in *Ex parte Cooper*. In *Re Yagerphone*, the liquidator sought to attack the provision of certain funds to a creditor, which funds were said to be subject to a debenture. The debenture holder was found to not be entitled to the proceeds of the preference action as he held a general or floating security interest in the debtor's property, rather than a fixed charge over those funds. As a result, the preference action could be pursued and the transfer was considered to be void solely as against the liquidator, with the recovered funds impressed with a trust in favour of the creditors generally.

Bennett J. stated at pp. 395-96:

There have been two cases which establish quite clearly that, whether in bankruptcy or in the liquidation of a company, a secured creditor has no right to enforce for his benefit the remedy which is given to a trustee in bankruptcy or the liquidator of the company of avoiding a payment or setting aside a transaction made or entered into with a view to preferring a creditor of the bankrupt or a company in liquidation. The authorities are *Ex parte Cooper* and *Willmott v. London Celluloid Co.*

Neither of these cases, as I have said, decides the point which arises on the summons. I propose to decide it in favour of the liquidators on this ground - namely, that, at the time when the securities contained in the debenture issued to H. Yager (London), Ltd., crystallised, the 240l. 11s. 2d. was not the property of Yagerphone, Ltd., the company which issued the debenture.

...

The right to recover a sum of money from a creditor who has been preferred is conferred for the purpose of benefitting the general body of creditors, and I think Mr. Montgomery White was right when he said that the sum of money, when recovered by the liquidators by virtue of s. 265 of the Companies Act, 1929, and s. 44 of the Bankruptcy Act, 1914, did not become part of the general assets of Yagerphone, Ltd., but was a sum of money received by the liquidators impressed in their hands with a trust for those creditors amongst whom they had to distribute the assets of the company. [Emphasis added; Citations omitted.]

[35] Air Canada submits that the reasoning of *Re Yagerphone* was adopted in *Re Maybank Foods Inc.* (1990), 72 O.R. (2d) 93 (S.C.), and *Re Oasis Merchandising Ltd.*, [1998] Ch. 170 (C.A.). In *Re Maybank*, the respondent had conceded that the proceeds of a preference action are held in trust for the general body of creditors. Air Canada frames the distinction drawn in *Re*

- Page 7 -

Oasis as between assets which were the debtor's property upon liquidation and may be subject to a charge, and those that were conveyed away to another creditor but recovered pursuant to a preference action, which are not subject to a charge. In other words, the court in *Re Oasis* drew a distinction between assets over which a secured creditor possesses a fixed charge at the time of liquidation, which are subject to the security, and assets which were conveyed to another creditor and recovered pursuant to a preference action, which were subject to a floating charge and, as such, not subject to the secured creditor's security. *Re Oasis* dealt with the proceeds of a wrongful trading claim, but the court nevertheless noted that the proceeds of preference actions are not company property, but rather, exist by virtue of liquidation and the liquidator's right of action, and are impressed with a trust in favour of the unsecured creditors. At pp. 181, the Court stated:

Thus a right of action against directors for misfeasance which the liquidator (amongst others) can enforce under section 212 of the Act of 1986 and the fruits of such an action are property of the company capable of being charged by a debenture, because the right of action arose and was available to the company prior to the winding up. But with this can be contrasted the right of action by a liquidator, and the fruits of such an action, for fraudulent preference or fraudulent or wrongful trading, which are not the property of the company and are not caught by a debenture: see *Gough, Company Charges*, 2nd ed. (1996), p. 122.

[36] Similarly, Air Canada notes that Millet J. in *In Re M.C. Bacon Ltd.*, [1991] Ch. 127 (Ch.D.), a case concerning whether the liquidator was entitled to recover its fees for the pursuit of a preference action, continued to apply *Re Yagerphone* to the determination of whether that preference action was properly brought so as to constitute an expense of the winding up payable out of the assets of the company. In making that determination, Millet J. noted that a preference action can only be made by a liquidator or administrator, and not a debentureholder because a debenture holder is bound by payments in the ordinary course of business even if the payment is preferential, whereas the liquidator is not. Millet J. wrote at p. 137:

It was thus established long before 1986 that any sum recovered from a creditor who has been wrongly preferred enures for the benefit of the general body of creditors, not for the benefit of the company or the holder of a floating charge. It does not become part of the company's assets but is received by the liquidator impressed with a trust in favour of those creditors amongst whom he has to distribute the assets of the company: see *In re Yagerphone Ltd.* [1935] Ch. 392.

Fraudulent preferences are only void as against the trustee

[37] Counsel to Air Canada submits that fraudulent preferences under s. 95 of the *BIA* are declared to be void *as against the Trustee* and not as against any other party, including secured creditors. Property recovered pursuant to a preference action is held by the Trustee for the benefit of the general body of creditors.

[38] Air Canada submits that the judgment of Hood J. in *S-Marque Inc. v. Homburg Industries Ltd.*, [1998] N.S.J. No. 550 (S.C.) aff'd for diff't reasons [1999] N.S.J. No. 94 (C.A.), endorses this view. In that case the deficit in the security of the secured creditor could not be paid in

priority from the proceeds of a preference action. Rather the secured creditor could claim for the deficit as an unsecured creditor. Hood J. reviewed the jurisprudence relating to the entitlement to the proceeds of preference actions and concluded at para. 147:

The effect of all these decisions is that overturning a fraudulent preference puts the property back in the hands of the trustee. The transaction is void as against the trustee in bankruptcy. The property does not, however, revert to the bankrupt to be available as part of the security over which a secured creditor has rights of seizure. [Emphasis added.]

[39] To similar effect, Air Canada submits that the court in *Canadian Imperial Bank of Commerce v. Canotek Development Corporation* (1997), 35 O.R. (3d) 247 (C.A.) (“*Canotek*”), stated at p. 256 that “[s]ection 95 renders a fraudulent preference void as against the trustee in bankruptcy; it does not render it void as against a secured creditor”.

[40] In *Canotek*, the bank held a general security agreement and chattel mortgage on the assets of F. Inc. (the debtor), which went bankrupt, but C. Corp, (the landlord of F. Inc.) levied distress against F. Inc without granting sufficient time for the tenant to rectify the situation. The court found that there was a fraudulent preference against the trustee, but not as against the bank. However, the landlord might still have rights under s. 136(1)(f) as a preferred creditor.

[41] The court rejected the bank’s argument regarding the reversal of priorities, stating at p. 251:

However, the bank says that but for the premature sale the property distrained would have been property of the bankrupt and, thus, subject to the bankruptcy. In that case, the bank argues, it would have been entitled to its security as against the trustee. In short, the bank argues that it has been deprived of the right to take advantage of the assignment in bankruptcy to gain priority in the goods and their proceeds over the trustee in bankruptcy. Since the trustee would have priority over the landlord’s distraint, the bank would thus have priority over the landlord as secured creditor in the bankruptcy. This is a tail-chasing type of priority problem which must be resolved by looking at the relationship between the true parties to the dispute. In this case, the bank never did have a priority over the landlord once the landlord distrained against the goods. The artificiality of looking to the bankruptcy proceedings to give the bank something the law never intended it to have is obvious, and should not be countenanced by the court.

[42] Intriguingly, the Court while noting, at p. 256, that “[g]enerally, provincial law governs priorities between various secured creditors, and also between secured creditors and landlords”, went on to state that “...outside bankruptcy the landlord prevails in facts such as these, and the incidence of bankruptcy should in no way alter this situation.”[Emphasis added.]

The Trustee is an impartial officer of the court

[43] Air Canada takes the position that the Trustee’s position in respect of the proposed preference action is inconsistent with its role as an impartial officer of the court submitting that a trustee should not act as an advocate for any particular class of creditors. Instead, its role is to

- Page 9 -

gather in the assets of the bankrupt and divide the proceeds in accordance with the scheme of the *BIA*: See *Re Bectown Honey Products Inc.* (2003), 46 C.B.R. (4th) 195 (Ont. S.C.) at para. 22, aff'd (2004) 3 C.B.R. (5th) 204 (Ont. C.A.).

[44] Air Canada submits that in bringing this preference action, the Trustee seeks to realize a benefit solely for Lloyd's, a secured creditor. The Trustee has also failed to involve the unsecured creditors and it has failed to disclose competing considerations that might indicate that this preference action is unwarranted. While the Trustee may act for a secured creditor pursuant to s. 13.4 of the *BIA*, Air Canada contends that the record does not indicate that it has met the statutory preconditions to assisting a secured creditor. Air Canada submits that the purpose of s. 13.4 is to protect unsecured creditors' rights: See *Pratchler Agro Services Inc. (Trustee of) v. Cargill Ltd.* (1999), 11 C.B.R. (4th) 104 (Sask Q.B.) at para. 9.

[45] Section 13.4 of the *BIA* provides:

(1) No trustee may, while acting as the trustee of an estate, act for or assist a secured creditor to assert a claim against the estate or to realize or otherwise deal with a security that the secured creditor holds, unless the trustee has obtained a written opinion from independent legal counsel that the security is valid and enforceable against the estate.

(1.1) Forthwith on commencing to act for or assist a secured creditor of the estate in the manner set out in subsection (1), a trustee shall notify the Superintendent and the creditors or the inspectors

- (a) that the trustee is acting for the secured creditor;
- (b) of the basis of any remuneration from the secured creditor; and
- (c) of the opinion referred to in subsection (1).

(2) Within two days after receiving a request therefor, a trustee shall provide the Superintendent with a copy of the opinion referred to in subsection (1) and shall also provide a copy to each creditor who has made a request therefor.

[46] Air Canada submits that the record before the court does not indicate that the Trustee has obtained a written opinion from independent legal counsel that the security in issue is valid and enforceable against the estate. There is also no evidence that the Trustee has notified the Superintendent in Bankruptcy and other creditors of such an opinion (if it exists), its intention to act for Lloyd's, or the details of any remuneration it may be receiving from the secured creditor.

The Trustee's Position

[47] The Trustee's position is that the jurisprudence is somewhat unclear, but the weight of jurisprudence favours granting the proceeds of preference action to secured creditors possessing a fixed, rather than floating charge, a finding that is reinforced by the structure of the *BIA* and the policy considerations underlying the *BIA*. As a result, the proceeds of this preference action ought to be paid to the secured creditor.

- Page 10 -

The distinction between fixed and floating charges

[48] The Trustee submits that Air Canada avoided a long-standing and obvious distinction between fixed and floating charges. Floating charges have been held to not attach to property that is the subject of a preference action. Conversely, fixed charges do: *Re Yagerphone*. This is because the secured creditor has no title when a charge is floating, yet gains priority where it is specific: *Bank of Montreal v. Innovation Credit Union*, [2010] 3 S.C.R. 3 at para. 46.

[49] Counsel to the Trustee submits that certain courts have interpreted *Re Yagerphone* overbroadly. *Re Yagerphone* concerned a dispute as to the priority as between a liquidator and a debentureholder over the proceeds of a preference action. The court held that the debentureholder's security did not attach to the assets at the time that they were transferred such that, in that case, the secured creditor had no greater claim to those assets than any other creditor.

[50] The Trustee acknowledges that *Re Maybank Foods* goes beyond the ratio in *Re Yagerphone*, yet contends that the overbroad interpretation of *Re Yagerphone* was based on a concession made by the respondent.

[51] The Trustee submits that the weight of case law favours the view that floating charges do not attach to assets recovered pursuant to a preference action; but, fixed charges do. In support of this position, the Trustee notes that: *Re M.C. Bacon Ltd.* (which found that preference action proceeds enure to the benefit of the general body of creditors) concerned a floating, rather than fixed charge; *Re Oasis* is the product of a technical reading of UK legislation; and *S-Marque Inc.* was affirmed for different reasons at the Court of Appeal, namely, that the debenture had not crystallized at the time that the asset was transferred away, such that the secured creditor was not entitled to the proceeds of a preference action. This is the same finding as the court in *Mohawk Sports Equipment* (1972), 17 C.B.R. (N.S.) 115 (Ont. S.C.), at paras. 16-17, which prevented the proceeds of a preference action being claimed by the holder of security that had not crystallized at the time of transfer.

[52] The Trustee points out that this distinction is found throughout the case law. Roy Goode in *Principles of Corporate Insolvency Law*, 3d ed. (London: Sweet & Maxwell, 2005) notes at s. 11-140:

All these cases assume that what is recovered by the liquidator either was never the property of the chargee or ceased to be so prior to the winding up as the result of the fact that the transfer in question overrode the charge. In such a case the chargee is not entitled to use the avoidance provisions to recover what he had lost or had never had. Where however, the charge was not overridden by the transfer and the property transferred is recovered, the charge continues to attach to the recovered property. [Emphasis added]

[53] The Trustee further submits that in *N.A. Kratzmann Pty. Ltd. (In Liq.) v. Tucker (No. 2)* (1968), 123 C.L.R. 295 (Qld. C.A.), the court noted in obiter at p. 302 that "if specific property, to which a charge, validly created by the bankrupt prior to his bankruptcy, has attached prior to the time of its disposition, is subsequently recovered as a preference the trustee's title will be no higher or better than that of the bankrupt to which he has succeeded". In arriving at this

- Page 11 -

conclusion, the court draws the distinction between specific property, that is subject to a charge, and over which the secured creditor will enjoy priority even if recovered pursuant to a preference, whereas property subject to a floating charge will not be subject to the charge when recovered by the trustee. The court reasoned at pp. 300-01:

Now in bankruptcy the property of a bankrupt vests in his trustee upon the making of the sequestration order. The property which so vests is, of course, subject, in the hands of the trustee, to any charges validly created in relation to it by the bankrupt prior to the bankruptcy. The position of a secured creditor who has a charge on specific property is, of course, not in question; such property in the hands of the trustee will still remain subject to the charge. But where security has been given by a bankrupt over all of his assets and a payment to a creditor is made by him out of moneys subject to the charge and the payment is, as against the trustee, subsequently declared void as a preference the moneys paid, when recovered, will not be subject to the charge. In such a case it may be said that although the moneys paid as a preference were at the time of payment subject to the charge, the moneys recovered by the trustee are not the same moneys and that they do not, by virtue of payment to the trustee, become moneys of the bankrupt or in any way subject to the charge; when recovered they become the moneys of the trustee and his title to them does not depend upon his succession to any title which the bankrupt had. It was, we think, in this sense that Bennett J meant in the passage that we have first cited that, applying the bankruptcy rules in a winding up,

“...the sum of money, when recovered by the liquidators by virtue of s 265 of the Companies Act, 1929, and s 44 of the Bankruptcy Act 1914, did not become part of the general assets of Yagerphone Ltd, but was a sum of money received by the liquidators impressed in their hands with a trust for those creditors amongst whom they had to distribute the assets of the company.”

The view which we have formed is, we think, borne out by the observations of Russell L.J. concerning the decision in *Yagerphone* case where, in *N.W. Robbie & Co. Ltd. v Witney Warehouse Co. Ltd.* he said:

“...that a claim by the liquidator for repayment to him of a fraudulent preference was not subject to the debenture-holder's charge; a statutory right in and only in the liquidator to make such a claim could never have been property of the company subject to the charge.”

It is of significance that his Lordship did not think that the decision in any such case could depend upon whether or not the charge had crystallized at the time when the payment to the creditor was made.

The case would be otherwise, of course, where a preference consists of the disposition of specific and identifiable property subject to a charge validly created in relation thereto by a bankrupt prior to his bankruptcy and where the avoidance

- Page 12 -

of the disposition affects title to such property. That this is so seems to us to be clear as a matter of principle....

In such a case the result of the avoidance of the disposition is to re-vest the property in the trustee subject to the charge which the bankrupt had validly created prior to the bankruptcy. [Emphasis added; Footnotes omitted.]

The Structure of the BIA

[54] The Trustee submits that the structure of the *BIA* favours giving the proceeds of a preference action to the secured creditor. Successful preference actions render transactions void as against the trustee as per s. 95 of the *BIA*. The property then vests in the Trustee as per ss. 67 and 71 of the *BIA*. However, the Trustee takes the property subject to the rights of secured creditors pursuant to s. 71, as the Trustee cannot obtain a greater interest in the goods than that enjoyed by the bankrupt: *Giffen (Re)*, [1998] 1 S.C.R. 91 at para. 50; *Lefebvre (Trustee of)*, [2004] 3 S.C.R. 326 at para. 37. Further, the Trustee reasons that division of the estate is subject to the rights of secured creditors pursuant to s. 136 of the *BIA*. As a result, secured creditors retain priority in those assets over which they had perfected security interests.

[55] The Trustee submits that the court in *Re ASI Acoustical Supplies Inc.* (2000), 22 C.B.R.(4th) 174 (B.C.S.C.), noted that the fact that only the trustee can bring a preference action does not disturb the priority rights of creditors to the proceeds of preference actions, stating at para. 20: “[i]n any event the fact that only a Trustee can make a claim alleging a fraudulent preference does not change the priority position of a secured creditor.

[56] The Trustee further submits that in *Agricultural Credit Corp. of Saskatchewan v. Featherstone (Trustee of)* (1996), 145 Sask. R. 161 (Q.B.), the court recognized that “[m]onies owing to a bankrupt, when collected by the trustee continued to be the property of the bankrupt and continue to be subject to the existing security interests. This includes monies realized through the efforts of the trustee” (citations omitted).

[57] The case of *Royal Bank of Canada v. North American Life Assurance Co. et al.*, [1996] 1 S.C.R. 325, cited by the Trustee, is not analogous, but potentially somewhat informative. The court found that s. 91 (dealing with whether settled property falls back into the estate) is subject to s. 67, insofar as s. 67 governs the disposition of assets in the estate. The court bifurcated the inquiry as follows at paras. 44, 45, 46, 48 and 49:

In reconciling ss. 67(1)(b) and 91 BIA, it is important to remember that the general scheme through which a bankrupt's estate is divided by the trustee among creditors involves two distinct stages. First, the Act provides that an insolvent person “may make an assignment of all his property for the general benefit of his creditors” (s. 49(1)), or that creditors “may file in court a petition for a receiving order against a debtor” (s. 43(1)). At the time of the assignment or receiving order, the trustee in bankruptcy is obligated to take possession of the assets forming the estate of the bankrupt. Thus, by operation of s. 71(2), the bankrupt's property passes to and vests in the trustee...

- Page 13 -

Once the bankrupt's property has passed into the possession of the trustee, the Act provides the trustee with the power to administer the estate...

During the property-passing stage of bankruptcy, the trustee is empowered under s. 91 of the Act to set aside certain settlements which have reduced the size of the estate. Thus, s. 91 outlines the circumstances in which a settlement will be voidable at the behest of the trustee in bankruptcy. If a settlement is declared void against the trustee, then the settled property reverts back to the bankrupt's estate, and falls into the possession of the trustee in bankruptcy...

...

However, the trustee is barred from dividing two categories of property among creditors: property held by the bankrupt in trust for another person (s. 67(1)(a)), and property rendered exempt from execution or seizure under provincial legislation (s. 67(1)(b)). While such property becomes part of the bankrupt's estate in the possession of the trustee, the trustee may not exercise his or her estate distribution powers over it by reason of s. 67.

Thus, it can be seen that ss. 91 and 67 relate to two different stages of bankruptcy. Section 91 dictates that certain settled property will fall back into the estate of the bankrupt in the possession of the trustee, while s. 67 is directed at the exercise of administrative powers over the estate by the trustee. Where a settlement is void against the trustee under s. 91, then in normal circumstances, the trustee is empowered to administer the settled asset, and use it to satisfy the claims of creditors. However, in the special case where the asset is exempt under s. 67(1)(b), then the trustee is prohibited from exercising his or her distribution powers because the asset is not subject to division among creditors.

[58] Counsel to the Trustee also references *Re Thorne, Ernst & Whinney Inc. and Gazzola et al.* (1989), 60 D.L.R. (4th) 590 (B.C.C.A.). In determining whether a landlord would be entitled to the proceeds of a preference action the Court of Appeal outlined the scheme of distribution as follows:

Under the Bankruptcy Act the trustee is charged with gathering the assets of the bankrupt for the benefit of creditors and then distributing those assets pursuant to the scheme of distribution set out in s. 136 of the Act. Section 95 is in that part of the Act that deals with schemes and preferences. Pursuant to s. 95 the trustee is entitled to consider any transaction involving a creditor of the bankrupt and if that transaction occurred within three months prior to the bankruptcy, the trustee can take steps to seek to establish that the transaction be deemed fraudulent and void as against the trustee...

...

In due course, depending on the claims of secured creditors and those standing in priority to the landlord under the scheme of distribution established by s. 136 of

- Page 14 -

the Act, if there are sufficient assets in the estate the landlord will then receive payment pursuant to the provisions of that section.

[59] The Trustee suggests that this reasoning was endorsed in *Canotek* at p. 256 where the Court of Appeal held that provincial law governs priorities between secured creditors and landlords and the incidence of bankruptcy should not disturb the order of priority present outside bankruptcy.

The policy underlying the BIA

[60] The Trustee submits that the policy underlying the *BIA* favours giving the proceeds of the preference action to the secured creditor, as this interpretation avoids altering priorities and nullifying a secured creditor's claim to collateral simply because a debtor has dealt with those assets preferentially. Otherwise, an insolvent person could defeat secured creditors' rights by granting a preference immediately prior to bankruptcy, with the resulting proceeds flowing to the benefit of unsecured creditors. This would be inconsistent with commercial sense, which the *BIA* seeks to protect.

[61] The Trustee notes that the courts have disallowed attempts to alter priorities through unlawful means. In *Anron Mechanical Ltd. v. L'Abbe Construction (Ontario) Ltd. (Trustee of)* (1991), 5 C.B.R. (3d) 133 at para. 9 (Ont. Gen. Div.), the specific and identifiable property (traceable moneys), that had been impressed with a trust did not lose that quality simply by virtue of being recovered as fraudulent payments:

If this were not so, a general contractor could then easily divert monies, defeat the rights of the unpaid subcontractors and thwart the whole purpose of the trust section of the Construction Lien Act. If he cannot divert the monies lawfully, as by assignment, then surely he cannot do so unlawfully, as by a fraudulent preference.

[62] The Trustee submits that the proceeds of a preference action ought to be paid in accordance with the hierarchy established in the *BIA*. Unsecured creditors do share rateably under s. 141, yet their claim is expressly subordinate to preferred creditors under s. 136, whose claim is itself subject to the rights of secured creditors.

[63] As a final point, the Trustee submits that this proposed action is not inconsistent with the role of the trustee. The trustee may act for secured creditors pursuant to s. 13.4 of the *BIA* if they have obtained a written opinion from independent legal counsel that the security is valid and enforceable. The Trustee contends that such an opinion was obtained and submitted in the Trustee's report filed on June 30, 2010.

[64] The Trustee also contends that it provided notice to the Superintendent and notified creditors before any action was taken on behalf of the lenders in accordance with the February 2010 Order. Further, it has: provided notice of its independent security opinion; posted this notice; and provided notice that it was bringing a preference action with the expectation that it would pay over the proceeds of that action to the secured creditor, Lloyds. As the Trustee is not receiving any remuneration from secured creditors, it provided no notice that it was receiving

- Page 15 -

remuneration from the secured creditor. Instead, the Trustee is funded by the Foreign Representatives who have been funded to date by monies in the estate.

2. Is the preference motion properly brought within the CCAA proceedings, or should it be reconstituted in the bankruptcy proceedings?

[65] Air Canada submits that this preference action is improperly brought. A preference action pursuant to s. 95 of the *BIA* can only be taken in Bankruptcy proceedings or, pursuant to s. 36.1 of the *CCAA*, a monitor (appointed pursuant to s. 11.7) may pursue a preference action where a plan of compromise or arrangement has been proposed. This preference action is not brought in bankruptcy and is not brought pursuant to a plan of arrangement, while the Trustee, as an Information Officer, is unable to bring an action that is reserved to a monitor.

[66] The Trustee submits that this Court dealt with this issue in its February 2010 Order dealt with this issue, with reasons reported at 2010 ONSC 1196. It held that concurrent *BIA* and *CCAA* proceedings are contemplated by Part IV; the preference motion is brought to maximize the Debtor Company's assets; failing to allow concurrent proceedings may preclude the review of what may in fact be a preferential transaction which is contrary to public policy; Air Canada commenced and then abandoned an appeal to this motion; such that, these issues are now *res judicata*. In any event, the Trustee contends that s. 42 of the *CCAA* intends for the *CCAA* to operate in tandem with the *BIA*: *Century Services Inc. v. Canada (Attorney General)*, [2010] 3 S.C.R. 379 at para. 76.

3. Should the February 2010 Order be varied to provide that the Trustee has to comply with certain obligations under the BIA?

[67] Air Canada notes that the February 2010 Order ought to be varied to ensure that the Trustee complies with its statutory obligations. To date, no proofs of claim have been sought from unsecured creditors, and no meeting of creditors has been convened to either consider the bankrupt's affairs, or hold a vote of the unsecured creditors to affirm the appointment of the Trustee, or substitute another trustee in its place, or to appoint inspectors to give direction to the Trustee. As a result, Air Canada submits that an order directing the Trustee to comply with its obligations under the *BIA* ought to be granted.

ADDITIONAL COMMONWEALTH JURISPRUDENCE

[68] The case of *Willmott v. London Celluloid Co.* (1886), 31 Ch. D. 425 (C.A.), appears to support the position of Air Canada, as the court held at pp. 435-36 that a preference action can only be pursued by a liquidator, while the proceeds are intended for the benefit of the general body of creditors: See also: *Re Quality Camera Co. Pty. Ltd.* (1965), 83 W.N. (Pt 1) 226 (N.S.W.S.C.); and *Bibra Lake Holdings Pty. Ltd. (in liq.) v. Firmadoor Australia Pty. Ltd.* (1992), 7 A.C.S.R. 380 (W.A.S.C.).

[69] Further support can be found in *Wily (in his capacity as Official Liquidator of Space Made Pty. Ltd. (in liq.)) v. St. George Partnership Banking Ltd.* (1999), 161 A.L.R. 1 (F.C.A.), in which no fraudulent preference was found as the payment was to a secured creditor, but the Federal Court of Australia helpfully mentioned three principles applicable to that context. The

- Page 16 -

first being that a debtor is entitled to prefer creditors subject to the *Statute of Elizabeth* 13 Eliz 1 c 5. The second and third principles are detailed at p. 5 as follows:

...in insolvency, by which I mean bankruptcy in the case of a natural person and liquidation in the case of a company, legislation provides that, with certain limited exceptions, all unsecured creditors of a bankrupt or an insolvent company are to be treated equally; that is, their liabilities are to be discharged rateably. This principle can be found in bankruptcy statutes dating back to 1542 (see 34 & 35 Hen 8 c 4, s 1 which was concerned with absconding debtors) and in company statutes since the Winding Up Act of 1844 (7 & 8 Vict c 111); see now s 108 of the Bankruptcy Act and s 555 of the Corporations Law.

The third principle is the recognition that certain dispositions made by a debtor who subsequently becomes bankrupt, or by a company that subsequently is wound up, should be recovered and be available to meet the claims of the creditors generally. Section 122 of the Bankruptcy Act is one example of the operation of this principle. Others are to be found in the Bankruptcy Act and the Corporations Law. Many other systems of law have comparable provisions. [Emphasis added.]

[70] In *Wily*, the Court found that if there is no detriment to the unsecured creditors, there can be no preference. Consequently, it would appear to be the case that if the proceeds of the preference action were to be co-opted entirely to the benefit of the secured creditors there would be no resulting benefit to the unsecured creditors, thereby precluding bringing a preference action in this situation. The Court in *Wily* stated at pp. 9-10:

If one asks whether there is less money available for the general body of creditors by reason of the three payments to the bank the answer must be a clear No. The reason is that if the payments had not been made the property available for distribution among creditors would not have increased. The bank would have been entitled to receive payment out of the property in the hands of the liquidator in priority to the other creditors. Any payment out of property that is not available to meet the debts due to the other creditors cannot confer a preference in favour of the payee. In this case then, the other creditors are not any the worse off by reason of the payments to the bank.

...

the short answer to the liquidator's submission is that provisions such as s 122 are designed to protect the statutory order of priority established by the Bankruptcy Act and, when it applies in a winding up, the statutory order established by the Corporations Law, the statutory order being the right to receive payments *pari passu*. Section 122 is not concerned to protect the rights of a creditor who is accorded priority by some other legislation, whether State or federal. [Emphasis added.]

- Page 17 -

(See also *St. Anne Nackawic Pulp Co. (Trustee of) v. Logistec Stevedoring (Atlantic) Inc.* (2005), 255 D.L.R. (4th) 137 (N.B.C.A.), which stands for the proposition that where a secured creditor is paid first there can be no fraudulent preference).

[71] Additionally, McPherson J.A., who expressed concurring reasons in *Starkey v. Deputy Commissioner of Taxation* (1993), 11 A.C.L.C. 558 (Qld. C.A.) stopped short of endorsing the view in *Re Yagerphone* that preference proceeds are impressed in the hands of the liquidators with a trust for unsecured creditors, but did accept that since a secured creditor cannot bring a preference action a trustee should not be allowed to bring a preference action for the sole benefit of a secured creditor. The rationale for preventing secured creditors from sharing in the benefits of a right of action of a trustee was elucidated at pp. 566-67:

If a secured creditor may not set in motion for his own benefit a procedure for avoiding preferences that exists for the benefit of the unsecured creditors, it is a logical consequence that he should not be able to claim the proceeds of avoiding such a preference when recovered. But it is another matter to say that the liquidator holds those proceeds in trust for the unsecured creditors if what is meant by that is a 'trust' in the full sense of the word, under which the unsecured creditors are equitable owners of the assets in winding up. There is little in recent decisions to support that view of the rights of creditors....

It is secured creditors who, under the decision in *Re Yagerphone Ltd*, are denied a share in the proceeds of avoiding preferences in winding up. Unlike the claimant in that case the Commissioner here is not a secured creditor with rights that are enforceable against identified property independently of winding up. [Emphasis added.]

[72] In *Bibra Lake Holdings Pty. Ltd. (in liq.) v. Firmadoor Australia Pty. Ltd.* (1992), 10 A.C.L.C. 726 (W.A.S.C.A.), Ipp J., in concurring reasons, held that fraudulent preferences are rendered void as against the liquidator only and the proceeds thereof do not form part of the assets of the company, writing at pp. 731:

Moneys paid in circumstances which create an undue preference, and which are recoverable under s 451(1), are moneys which are recoverable for the benefit of the creditors and contributories. Such moneys cannot be said to have been the property of the company.

...

Undue preferences are void as against liquidators, not as against companies. Section 451 confers upon liquidators the sole right to bring proceedings for the recovery of undue preferences. [Emphasis added.]

[73] Since *Re Yagerphone*, the governing UK law has been amended, including, in particular, by the 1985-86 reforms to the *Insolvency Act* (U.K.), 1986, c. 45, with the consequence that the court can now make an order to restore the *status quo ante* as if there had never been a preference. Nevertheless, despite these broadened powers, Millet J. found in *Re M.C. Bacon Ltd. (No. 2)* that *Re Yagerphone* remained applicable at p. 137:

- Page 18 -

It was thus established long before 1986 that any sum recovered from a creditor who has been wrongly preferred cures for the benefit of the general body of creditors, not for the benefit of the company or the holder of a floating charge. It does not become part of the company's assets but is received by the liquidator impressed with a trust in favour of those creditors amongst whom he has to distribute the assets of the company: see In re Yagerphone Ltd. [1935] Ch. 392....

In my judgment that is still the law, notwithstanding section 239(3) of the Act of 1986 which empowers the court on finding a voidable preference proved to make such order as it thinks fit for "restoring the position to what it would have been if the company had not given that preference," and section 241(1)(c) which empowers the court to "release or discharge . . . any security given by the company." Those powers are not intended to be exercised so as to enable a debenture holder to obtain the benefit of the proceedings brought by the liquidator.[Emphasis added.]

[74] In *Tolcher v. National Australia Bank Ltd.* (2003) 44 A.C.S.R. 727 (N.S.W.S.C.), Palmer J. found that where a settlement was paid from the estate subject to a charge in the form of a general security agreement against all assets of the bankrupt (which was characterised as a floating charge, rather than a specific charge), the monies recovered pursuant to a preference action to impugn that settlement are not subject to the charge as the trustee's title is not dependent on the debtor's title, nor can it be in the case of a statutorily-provided right of action.

[75] Somewhat more nuanced support for Air Canada's position can be found in the case of *N.W. Robbie & Co. Ltd. v. Witney Warehouse Co. Ltd.*, [1963] 1 W.L.R. 1324 (C.A.). In that case, which had to do with whether certain debts could be set off rather than whether preference proceeds could accrue to secured creditors, Russell L.J. at p. 1338 rejected the suggestion that *Re Yagerphone* stands for the proposition that a charge cannot attach to assets acquired after the date of crystallization, noting instead that it stands for the proposition that proceeds from a liquidator's right to pursue a preference action, being a liquidator's right, cannot be property of the company subject to the charge. Russell L.J. stated at p. 1338:

We were referred, in the course of the argument that there is no charge on the post-receivership "future assets," to a phrase in Kerr on Receivers (1963), 13th ed., p. 327, which says the charge would not attach to assets of the company acquired subsequent to the date of crystallisation." The authority cited is *In re Yagerphone Ltd.* The quotation, divorced from its context, is too wide to be supported, and if so divorced is not justified by that decision, which was that a claim by the liquidator for repayment to him of a fraudulent preference was not subject to the debenture-holder's charge: a statutory right in and only in the liquidator to make such a claim could never have been property of the company subject to the charge. [Emphasis added.]

[76] Further support can be found in the case of *Horn v. York Paper Co. Ltd.* (1991), 5 A.C.S.R. 112 (N.S.W.S.C.), McLellan J. stated at p. 113:

Where a transaction is avoided as against a liquidator by virtue of the operation of s 451 of the Companies Code (or s 565 of the Corporations Law) the liquidator is a necessary party to proceedings for the recovery of property or money based on such avoidance: see *Kent v La Communauté des Socurs de Charité de la Providence* [1903] AC 220 at 226. This is because the transaction is avoided only against the liquidator, and the proceeds of recovery do not necessarily form part of the general assets of the company: see; *Rc Quality Camera Co Pty Ltd* [1965] NSW 1330; 83 WN (Pt 1) (NSW) 226 and; *N A Kratzmann Pty Ltd (in liq) v Tucker (No 2)* (1968) 123 CLR 295." [Emphasis added; See also *Bibra Lake*, holding to the same effect.]

[77] In *Bayley v. National Australia Bank Ltd.* (1995), 16 A.C.S.R. 38 (Tas. S.C.), Wright J. was tasked with determining whether funds recovered via a s. 468 action under the Australian *Corporations Law* (which renders dispositions after a winding up void), as well as funds recovered pursuant to a preference action, were subject to a secured creditor's registered floating charge. Wright J. held that the disposition successfully challenged via s. 468 were void for all purposes, as if the payment had never occurred, such that the funds "remained the property of the company at all relevant times and upon being restored to the company by the liquidator's actions became once more subject to the respondent's floating charge." Wright J. then went on to deal with the question of whether the charge attached to the assets recovered pursuant to the preference action.

[78] Wright J. held that the proceeds of a preference action were for the benefit of the general body of creditors. Wright J. noted that "unlike dispositions affected by s 468(1), preferences coming within the ambit of s 565(1) are not void in any absolute sense but are void as against the liquidator only." It was not necessary for Wright J. to decide whether this would mean that the recovered property could be said to be free and clear of any prior charges, (although it was noted that this may be true of specific property subject to a charge prior to a winding up order) since, in the circumstances of that case, the charge at issue was floating and had not crystallized prior to the liquidation proceedings, such that it did not attach to the funds that were preferred. Instead, those funds were held for the benefit of the general body of creditors. Wright J. concluded:

...irrespective of whether for some purposes the recovered funds may be viewed as the "property" of the company being wound up, in the present circumstances they are not property which was or could have been subject to the floating charge at the time that charge crystallised viz. the date upon which liquidation proceedings commenced. Thus, in my opinion, the fund constituted by those moneys is not available to the respondent, but is distributable to the general creditors subject only to the statutory priorities provided by the Corporations Law.

[79] The import of the words "void as against the trustee" was the subject of judicial consideration by the New South Wales Court of Appeal in *National Acceptance Corporation Pty. Ltd. v. Benson & Ors* (1988), 13 A.C.L.R. 1 (N.S.W.S.C.A.), where the Court held that the use of the word "void" in s. 368 of the Companies Code in question (which is similar to s. 468 of the Corporations Law considered in *Bayley*) "...means at least void for all purposes related or incidental to the administration of the winding up of the company" in contrast to the use of the word "void against the trustee" in their *Bankruptcy Act* which is more narrow. On this point, the

- Page 20 -

Court noted that in *Commercial Bank of Australia v. Carruthers* (1964), 6 F.L.R. 247 (F.C.A.), Manning J. “held that the provision did not produce the result that the preferential payment was void against anyone else than the Trustee in Bankruptcy” (emphasis added).

[80] Andrew Keay in “The Effects of a Successful Action by a Liquidator to Avoid a Pre-Liquidation Transaction” (1996) 15 (2) U. Tasm. L. Rev. 236 notes that the Australian bankruptcy regime has changed such that now transactions are no longer said to be “void as against the liquidator” but rather “voidable”, and further, recovery vests in the company. He submits at p. 241 that this is a difference without a distinction as in the U.K., where the *Insolvency Act* grants the court broad powers to void fraudulent preferences and restore the position to the *status quo ante*, the courts have continued to apply *Re Yagerphone*. For instance, in *Re M.C. Bacon Ltd. (No. 2)*, *Re Yagerphone* was again endorsed as holding that secured creditors cannot recoup the proceeds of a preference action despite a similar change in wording as Australia’s under the U.K. *Insolvency Act*.

[81] In that article, Andrew Keay also notes that *Re Yagerphone* has existed for a long period of time and the government had the option to disturb this judicial practice but did not do so, nor is there evidence in the speeches of Parliament or the Explanatory Memorandum relating to the U.K. Bill that changed the U.K. *Insolvency Act* most recently that a change in judicial practice was contemplated, let alone required.

[82] In addition to Andrew Keay’s comments, it should be recalled that s. 95 of the *BIA* is worded more restrictively than the U.K. or Australian preference provisions, rendering fraudulent preferences void against the trustee only.

[83] Andrew Keay does not regard reversing priorities as a problem, so much as a function of the legislative scheme itself. He writes at p. 264, in relation to the reversal of priorities:

With respect, it appears that this argument overlooks the fact that bankruptcy or liquidation changes everything. While the company continues to exist, it is no longer directed by directors, and it is not run for the benefit of the shareholders. A liquidator acts on behalf of the company and he or she does so for the general body of creditors. Liquidation produces a whole new set of relationships and duties. While a secured creditor may argue that the general creditors are sometimes unjustly enriched by receiving the benefits of a recovery, the rebuttal to that might be that those creditors were prejudiced before liquidation because they did not receive any benefit from the voidable transaction and, in any event, they have suffered losses as a result of the liquidation. [Citations omitted; emphasis added.]

[84] It could be argued that while priorities may well be reversed, as held in the case law, this stems from the role of the trustee. The status of the trustee is tripartite: as a successor in title, as a representative of creditors and finally, and importantly, the trustee has independent status under either federal or provincial law to avoid certain transactions: *Roderick Wood, Bankruptcy and Insolvency Law* (Irwin Law: Toronto, 2009) at pp. 180-81. As such, as Professor Wood notes at p. 82 the principle that a trustee “steps into the shoes” of the bankrupt and acquires the bankrupt’s property “warts and all” “does not operate where bankruptcy or other legislation

gives the trustee a power to subordinate or avoid certain property rights of third parties. In such cases, the trustee may have a better right to the asset than that held by the bankrupt.”

[85] This may constitute an oddity, but the danger of legislative intrusion outweighs any possible unfortunate consequences from the reversal of priorities. While the legislative measure could be an oddity, this would not be anomalous. As Professor Ian Fletcher writes in *The Law of Insolvency*, 4th ed. (London: Sweet & Maxwell, 2009) of the legislative history of British bankruptcy law at pp. 796-97 as follows:

...the legislative history is scarcely homogeneous, but is more accurately described as one of almost perpetual accretion and revision amid shifting socio-political influences. It must be submitted that the current position, in terms of policy and principle, is both muddled and confusing. It has resulted from the historic lack of a co-ordinated, thought-through approach to our law of credit, security and insolvency, amounting to a persistent failure...to address the essentially interlocking and inter-dependent nature of these vital areas. Consequently, the law has become beset by anomalies and inconsistencies, particularly concerning the operation of the *pari passu* principle, which are in some instances squarely at odds with commercial and social realities....

[86] However, there is also jurisprudence and commentary in support of the Trustee's position. Doyle C.J., for the majority, in *Fresjac Pty. Ltd. (In Liq, Re Campbell v. Michael Mount PPB)*, (1995), 65 S.A.S.R. 334 (S.A.S.C.), approved of *N.A. Kratzmann*. This was cited by counsel to the Trustee, and reconciled many of the prior Commonwealth cases mentioned above by distinguishing the issue of who possesses the right to bring a preference action, from the issue of the entitlement to the proceeds of such actions. The Court in *Fresjac* was faced with the issue of to whom the proceeds of a s. 468 action by the liquidator, which renders dispositions of property after the commencement of winding up void, accrue. Doyle C.J. noted that the purpose of this section is identical to the purpose underlying preference actions, writing at pp. 341-42 “...both have an eye to the preservation of assets, to the preservation of the *status quo*, and to a later orderly distribution of assets among creditors, subject to the rights of secured creditors” (emphasis added).

[87] In *Fresjac*, Doyle C.J. disagreed with Wright J.'s conclusion in *Bayley* that funds rendered void under s. 468 were at all times the property of the company and became subject to the charge once restored to the company. Doyle C.J. opined that such a characterization is artificial. The funds recovered were not the same funds, and title could not be re-vested, although this could occur in the case of land or identifiable chattel. Instead, the company would have a claim to recover an equivalent amount of money and its entitlement to the funds of s. 468 is a separate question from the right to impugn a transaction. Wright J.'s reliance upon the fact that a s. 468 action is “void”, whereas a preference action is “void as against the liquidator” is, in Doyle C.J.'s view at p. 344, misplaced, as those words “control who may invalidate the preference, and to identify the liquidator as the person with that right, not to decide or determine who is entitled to the proceeds.”

[88] In this regard, Doyle C.J.'s analytic framework is noteworthy and worth setting out. It was noted that there is a “need to distinguish between the avoiding effect of the section, the

- Page 22 -

location of the right to recover property disposed of by the company in a transaction avoided by the section, and the entitlement apart from that to rely upon the avoiding effect of the section.” Doyle C.J. wrote at p. 344-45:

The preference cases indicate, in my opinion, that the right to recover property disposed of in a transaction avoided as a preference belongs to a trustee in bankruptcy or liquidator, and property recovered by the exercise of that right will not vest in a secured creditor unless the exercise of the right should cause the re-vesting of title in specific property subject to a security.

....

...the location of the right to assert voidness does not also determine the location of the right to proceeds recovered after the cancellation of a void transaction.

...

The mere right to assert or rely upon voidness cannot, as a matter of logic, give rise to a right to recover the property disposed of by the void transaction.

The right to recover property disposed of in a transaction voided by s 468 is not property of the company, and the proceeds of the exercise of the right do not fall to be treated as property of the company caught by pre-existing charges or security but, in my opinion, specific property the subject of a charge or security will, if recovered, again be subject to that charge or security.

On this approach, the right to recover property the disposition of which is avoided by s 468 is not a right to which a charge or security will attach.

In addition, in my opinion money recovered as the result of the avoidance of a preference or because a payment is void is not to be regarded as property of a company to which a charge or security can attach.

These conclusions emphasise the similarity between the preference provisions and s 468, despite the difference of language (void as against the liquidator and void) and despite the difference in the stages before liquidation to which they apply and the differences in the manner in which they operate.

On the other hand they avoid the oddity (as some would see it) of a better result for a secured creditor in respect of a void payment, and the oddity of a remedy conferred for the purposes of a liquidation working for the benefit of the secured creditor. I do not pretend the result which I have reached is obvious, or that the contrary arguments are lacking in substance. [Emphasis added.]

[89] In addition, in *Bank of New Zealand v. Essington Developments Pty. Ltd. & Ors*, (1991), 5 A.S.C.R. 86 (N.S.W.S.C.), it was held that a secured creditor has the benefit of a liquidator's recovery of assets *in specie* over which a secured creditor has a charge. McLelland J. wrote at pp. 89-90:

- Page 23 -

The position of a creditor with a charge over all the assets of a company and a receiver appointed by that creditor appears to be that if as a result of the avoidance of the transactions property is recovered in specie, then that property is included in the assets of the company which are subject to the charge and which therefore are available to the receiver for the benefit of the secured creditor. On the other hand, moneys which are recovered merely because payments have been avoided as preferences do not come within the general assets of the company available for the secured creditor and the receiver, but may be utilised by the liquidator for the purposes of the liquidation, and in particular for the benefit of unsecured creditors. [Emphasis added.]

[90] In *Re Shapland Inc.*, [2000] B.C.C. 106 (Ch.D.), the court appears to be of the view that a trustee can pursue a preference action for which the benefits will accrue to the secured creditor (although in that case unsecured creditors would actually benefit as well) in stating at p. 110:

Mr Goodison submitted that I should make no such order, on the ground that it would benefit only the bank, which was a secured creditor, and the power under s. 239 was conferred to benefit unsecured creditors, not secured creditors. I am very doubtful that this submission would be correct, even if the bank's claim were fully secured. However, on the facts of this case, it is not: the indebtedness of Shapland to the bank greatly exceeds the value of the property, so that a large part of the bank's claim is unsecured. Furthermore, the bank's security has been challenged, so that it would be wrong for me to proceed on the assumption that it is unquestionably a secured creditor. Lastly, the bank and the liquidator, who is financed in these proceedings by the bank, have agreed that after payment of the costs and expenses of the winding up, ten per cent of the proceeds of sale of the property are to go to unsecured creditors. Accordingly, the setting aside of the charge will benefit unsecured creditors, and the factual basis for Mr Goodison's submission is not made out. [Emphasis added.]

[91] In *The Law of Insolvency*, Professor Fletcher would appear to provide some support for the Trustee's position, in claiming that the purpose of a preference action is to restore the situation to the *status quo ante*, and that the court may make such order to achieve that purpose as it sees fit, such that the idea that the proceeds of the action are not subject to the rights of secured creditors would be put into doubt. The new broad power to strike down fraudulent preferences, declare them void, and make any order that is just, was introduced in the 1985-86 reforms to the *Insolvency Act* in England. However, as previously noted, this form of relief is not replicated in the *BIA*.

[92] Professor Fletcher also notes that the trustee's title is subject to various equities. He states at p. 246 that in the individual debtor context, whereby preferences can be declared void to restore the *status quo ante* (much like in the company debtor context), "the trustee is essentially a successor to such title as the bankrupt actually had at the time of his adjudication, including any limitation or imperfections in that title, and can enjoy no better position in relation to the property than did the bankrupt himself formerly" (emphasis in original; citations omitted), relying on *Johnson v. Smiley* (1853), 51 E.R. 1019 (Ch.D.); *Mapleback, Re* (1876), 4 Ch.D. 150 (C.A.);

- Page 24 -

Garrud, Re (1880), 16 Ch.D. 552 (C.A.), per James L.J.; *Beeston, Re*, [1899] 1 Q.B. 626 (C.A.) at p. 610 per Lindley M.R.

[93] More forcefully, he states at p. 247 “[a]ll such rights as might have been exercised by third parties prior to bankruptcy may be exercised after adjudication, and no action by the trustee can be effective to gain priority over such vested rights: unless the property can be disclaimed, the rights remain undisturbed” relying on *Anderson, Re*, [1911] 1 K.B. 896 (Ch.D.).

[94] The Trustee’s position is supported by additional academic literature. Rebecca Parry in “The Destination of Proceeds of Insolvency Litigation” (2002) 23(2) Comp. Law. 49, is concerned about the reversal of priorities that occurs where secured creditors cannot recoup the benefits of a preference action brought by a trustee under English law, especially given the anomaly that many preference actions could be pursued as misfeasance claims that do not give rise to the same result. This is because in the misfeasance context, amounts recovered are recoverable by secured creditors: See *Re Produce Marketing Consortium Ltd. (No. 2)*, [1989] B.C.L.C. 520 (Ch.D.); *Re Asiatic Electric Co. Pty. Ltd. (in liq.)* (1970), 92 WN (N.S.W.S.C.) at pp. 362-64. The remainder of her article deals primarily with the particular wording of the U.K. law.

[95] Lee Eng Beng in “The Avoidance Provisions of the Bankruptcy Act 1995 and their Application to Companies” (1995) Sing J. Legal Stud. 597 notes that even with respect to preferential dispositions of specific property, the right to recover the assets vests in the liquidator such that a chargee cannot be entitled to the fruits of that recovery, especially since the process itself is intended for the benefit of unsecured creditors rather than secured creditors, as the latter exist outside of the bankruptcy regime. Nonetheless, Lee Eng Beng acknowledges the rights of secured creditors to trace monies at p. 632:

While the property which has been disposed of may have been validly charged, the fact of it being wrongfully disposed of gives rise to the chargee’s right under the general law to trace against the disponee and nothing more. The rights and remedies of secured creditors are conferred by the general law and they are not to be reinforced by statutory provisions designed to provide an equitable debt collection system for unsecured creditors. Of course, any right of a secured creditor which exists at general law would override any right of the liquidator or trustee in bankruptcy to proceed against the assets by virtue of any statutory provision, as the latter cannot be in a better position than the company or bankrupt, as the case may be. It follows that if a secured creditor has the right to recover the assets transferred away in breach of his security rights and the liquidator or trustee in bankruptcy recovers the assets pursuant to the statutory provisions, any recovery by the latter must be held for the benefit of the former in so far as they would have been recoverable by the secured creditor. [Emphasis added.]

[96] Gerard McCormack in “Swelling Corporate Assets: Changing What is on the Menu” (2006) 6 J. Corp. L. Stud. 39 advances five reasons at pp. 56-57 for doubting the line of cases affirming *Re Yagerphone*, two of which are not peculiar to the English context:

- Page 25 -

1. *Re Yagerphone* gives rise to the unprincipled anomaly that certain preference actions can also constitute misfeasance actions, yet only in the latter case are payments subject to the rights of secured creditors.
2. Too much emphasis is placed on the liquidator's independent status which is merely an administrative convenience. He states that "the fact that proceedings are brought by the liquidator or administrator might be seen as largely procedural. The liquidator or administrator are not acting in their own individual rights but rather by virtue of the office they hold in relation to a particular company. In a broad sense the proceedings are brought on behalf of the company in question." (Citations omitted; emphasis added.)

[97] Nancy Sanborn supports this interpretation, admittedly in the U.K. context. She writes in "Avoidance Recoveries in Bankruptcy: For the Benefit of the Estate or the Secured Creditor?" (1990) 90 Colum. L. Rev. 1376 at 1399-1400 supports the above authors writing:

The proposition that all amounts recovered must be available for administrative expenses and unsecured claims and interests, without recognition of any security interest in the recovery because avoidance powers are exercised for the benefit of the estate, fails to distinguish between two separate functions of the bankruptcy process. One function is to maximize the value of the pool of assets to which all claimants and interest holders will look for payment. Transfers are avoided, then preserved or recovered, to serve this function. The estate benefits from the exercise of these powers even if a creditor possesses a security or beneficial interest in the property.

A separate issue, how entitlements to the accumulated pool of assets should be allocated, should be resolved primarily by nonbankruptcy law. A secured creditor should be afforded the same protections that would have been available to it under state law if no bankruptcy had ensued. [Citations omitted].

ANALYSIS

[98] The foregoing review of jurisprudence confirms the submission of the Trustee, namely, that the jurisprudence is unclear and inconsistent. However, it seems to me that, with a consistent application of (i) insolvency principles; and (ii) personal property security principles, the jurisprudence can be reconciled.

[99] Both the Trustee and Air Canada make extensive reference to the English decision of *Re Yagerphone*. *Re Yagerphone* has been cited by some Canadian courts to stand for the proposition that secured creditors have no claim to the proceeds of a preference action.

[100] Counsel to the Trustee submits that, read properly, the holding in *Re Yagerphone* is, in fact, narrower. I agree.

[101] In *Re Yagerphone*, the court considered a priority dispute between the liquidator and a debenture holder over the proceeds of a preference action. In reaching its conclusion, the court focussed on the nature of the debenture holder's security. The court observed that at the time the

- Page 26 -

preference was given, the debenture holder's charge was still floating and therefore had not attached to the assets of *Re Yagerphone*:

On January 17, 1933, the creditor to whom the money was paid and from whom the money was recovered was a creditor Yagerphone, Ltd. When Yagerphone, Ltd. paid to the creditor the 2401 11 s. 2 d. that sum, in my judgment ceased to be the property of Yagerphone, Ltd. The payment to that creditor could not have been attacked or impeached, unless within three months from the date of payment, the liquidation of Yagerphone, Ltd. had begun, and, in my judgment, at the date when the security contained in the debenture crystallised, the sum of 2401 11 s. 2 d. was not the property of Yagerphone, Ltd....

[102] As counsel to the Trustee points out, at the time the preference was given by the debtor, the assets transferred were not subject to the debenture holder's security and when the debenture holder's security was crystallized, the debtor's estate did not extend to the assets that had already been transferred on account of the preference. On this basis, the court found that the debenture holder's security did not attach to those assets when they were eventually returned to the estate.

[103] Counsel to the Trustee goes on to submit that, from a policy perspective, the holding in *Re Yagerphone* is not unreasonable, as, in particular, because the debenture holder's security was floating it had no claim to the assets. When these assets were brought back into the estate, the court's decision that all creditors share in those assets is consistent with the fact that the "fraud" occurred against all of the debtor's creditors.

[104] In *Mohawk Sports Equipment* Houlden J. (as he then was) applied *Re Yagerphone* in circumstances which involved a floating charge that had not crystallized. The court held that the proceeds "cannot be claimed by the debenture holder as it was not part of the property of the debtor company at the time the security was crystallized".

[105] Counsel to the Trustee further submits that in subsequent cases, the holding in *Re Yagerphone* has been summarized more broadly to apply to secured creditors generally. Reference was made to *Re Maybank* where at paragraph 2 the court stated:

It is conceded by the respondent that the monies recoverable by a trustee from a creditor who has been preferred do not become part of the general assets of the bankrupt estate subject to the claims of secured creditors but rather are received by the trustee subject to a trust in favour of the creditors represented by the trustee: *Re Yagerphone, Ltd.* (1935) 1 Ch. 392 (Ch. D.).

[106] It is the Trustee's submission that the concession in *Maybank Foods* goes beyond the ratio in *Re Yagerphone* as the reasoning in *Re Yagerphone* does not necessarily follow the circumstances in which a secured creditor holds a fixed charge over the assets of the debtor. Counsel goes on to submit that where the secured creditor holds a fixed charge, the policy considerations are different. Unlike a floating charge, a fixed charge gives the secured creditor a property interest in the debtor's collateral that attaches at the time the charge is granted. Reference was also made to the recent decision of the Supreme Court of Canada in *Bank of Montreal v. Innovation Credit Union*, [2010] 3 S.C.R. 3, which, in turn referred to the case of

- Page 27 -

Royal Bank of Canada v. Sparrow Electric Corp., [1997] 1 S.C.R. 411, in which the distinction between a fixed and a floating charge was explained at para. 46:

The critical significance of the characterization of an interest as to being fixed or floating, of course, is that it describes the extent to which a creditor can be said to have a proprietary interest in the collateral. In particular, during the period in which a charge over inventory is floating, the creditor possesses no legal title to that collateral....However, if a security interest can be characterized as a fixed and specific charge, it will take priority over a subsequent statutory lien or charge; in such a case, all that the lien can attach to is the debtor's equity of redemption in the collateral....

[107] The distinction between a fixed and floating charge and considering whether the charge has crystallized is not a new concept. The issue was also live in *Maybank Foods*.

[108] In *Maybank Foods*, the respondent was a secured creditor of the estate. The estate had been engaged in three actions in Nova Scotia referred to as the Food Group Litigation, the Provisioners Litigation, and the Seaway Litigation, respectively. The trustee requested orders that the proceeds from such litigation were the property of the estate free and clear of the secured claim of the respondent.

[109] At para. 2 of the decision, Saunders J. referenced the Provisioners Litigation and the Seaway Litigation as involving claims against preferred creditors. It was in this context that the concession was made by the respondent that the monies recoverable by the trustee would not form part of the general assets of the estate.

[110] However, at para. 3 of the decision, Saunders J. addresses the claim against Food Group:

The claim against Food Group was in respect of an account receivable. Food Group unsuccessfully defended the claim of the trustee on the basis of set-off. It was held that in the circumstances there was no mutuality, because at the time the bankrupt became indebted to Food Group, the receivable was being claimed by another secured creditor, Citibank under a crystallized charge. Upon the bankruptcy, the receivable of Food Group vested in the trustee subject to the secured claim of the predecessor in title of the respondent. Accordingly, the respondent may assert a right to the proceeds of the Food Group Litigation unless defeated by some principle or a statute. The situation is different from the other two actions where the respondent had no charge on the property being claimed by the trustee and the trustee was asserting a statutory right unavailable to the respondent. Here, the respondent has a charge on the receivable being claimed from Food Group. The trustee argued the respondent could not have successfully claimed against Food Group because Food Group would have been entitled to a set-off which in its submission made the situation analogous to the other two actions. I cannot accept that argument. The action of Citibank in crystallizing its charge foreclosed the Food Group from successfully asserting the set-off defence. In my opinion, the respondent who also had a charge against that asset could assert along with the trustee that set-off is not available notwithstanding the

- Page 28 -

charge to the respondent may not have crystallized before the claim of Food Group against the bankrupt arose. There is, in my opinion, no basis in statute or principle preventing the respondent from claiming the net proceeds of the Food Group action.

[111] Justice Saunders endorsed the record as follows:

Net proceeds (after deducting of costs and disbursements) of Food Group Litigation are subject to the secured claim of the respondent. Proceeds of the Provisioners Litigation and the Seaway Litigation are free and clear of such claim. The costs and disbursements with respect to the Provisioners Litigation and the Seaway Litigation should not be paid out of the assets of the estate that are subject to the secured claim of the respondent unless that claim has been satisfied in full. Costs to the trustee and to the respondent out of the estate on a solicitor-and-client basis.

[112] The distinction between a fixed charge and a floating charge was also the subject of the decision of the Nova Scotia Court of Appeal in *S-Marque*.

[113] In *S-Marque*, the Nova Scotia Supreme Court found that the proceeds of a preference action will inure to the benefit of the unsecured creditors for two reasons:

- (a) first, the court relied on the decision *In Re Yagerphone*; and
- (b) second, the court cited a number of decisions to the effect that only a trustee can void a preference action.

[114] The decision was affirmed on appeal but the Court of Appeal decided the priority issue for different reasons. The Court of Appeal focussed on the fact that the secured creditor held a floating charge and that the preference occurred "before the debenture crystallized". As counsel to the Trustee reasoned, as in *Mohawk Sports Equipment*, the court determined the matter on the basis that the secured creditor "never had a fixed charge on these assets when the debenture crystallized".

[115] Counsel to the Trustee submits that the court considered the priority rights of secured creditors to proceeds from a preference action and that in the 2000 British Columbia Supreme Court decision, in *Re ASI Acoustical Supplies Inc.*, the court squarely addressed the fact that only a trustee can make a claim for fraudulent preference under the *BIA*. Counsel to the Trustee submits that the court noted that, while the *BIA* gave that right to the trustee, it did not change the priority rights of creditors to the proceeds.

[116] In my view, the *ASI Acoustical* decision does not stand for the proposition put forth by counsel to the Trustee.

[117] The matter came before the court by way of an appeal by the trustee for *ASI Acoustical* from a decision of the Registrar, refusing to approve the payment to the trustee of its fees and disbursements. The Bank of Nova Scotia took security in the form of a general security and assignment of accounts receivable. The security was ultimately assigned to Mr. Willsie.

- Page 29 -

[118] Prior to bankruptcy, ASI bought materials from Winrock and owed Winrock around \$56,000. Winrock then bought a substantial amount of ASI inventory. Winrock owed ASI approximately \$45,000 for the inventory, but resisted payment claiming a right of "contra account". The trustee wrote to Winrock noting that a subsidiary company Hubcity owed part of the money to ASI and therefore the claim of "contra account" could not be made out. The trustee also alleged that the Winrock claim was a preference on the basis that the sole reason Winrock bought the inventory from ASI was to reduce its claim in the bankruptcy.

[119] Ultimately, the matter was settled. The position of the trustee was that the matter was settled on the basis that the purchase of inventory was a fraudulent preference under the provisions of the *BIA* and because this remedy is not available to the secured creditor, the money obtained from the settlement was an asset of the estate.

[120] The registrar held that there was no dispute that the account receivable from Winrock was covered by the security interest, and the fact that there were negotiations and the claim was eventually paid because the trustee alleged that there was a fraudulent preference, did not convert the asset into some other kind of asset not subject to the security interest. The registrar therefore found that the proceeds of the claim should not appear on the statement of receipts and disbursements as an amount available to the estate.

[121] At the hearing before Martinson J. on appeal, the creditors disputed the characterization of the transaction as a fraudulent preference. The only evidence before the registrar was that there had been an allegation of a fraudulent preference by the trustee, that no claim had been commenced by the trustee and that there was a negotiated settlement with Winrock.

[122] Justice Martinson concluded that it was open to the Registrar, based on the material before her, to conclude that the settlement monies were accounts receivable and subject to the security interest. It was in this context that the reference which was cited by counsel to the Trustee: "[i]n any event, the fact that only a trustee can make a claim alleging a fraudulent preference does not change the priority position of a secured creditor" was made.

[123] From my reading of *ASI Acoustical*, the significant point is that the court recognized that in the circumstances of that case, the fact that a fraudulent preference action had commenced, did not preclude the ability of a secured creditor to realize on security or to follow the proceeds from security in accordance with the specific security agreement.

[124] This position is again recognized in *Agricultural Credit Corp. of Saskatchewan*, where the court noted:

Monies owing to a bankrupt, when collected by the trustee continue to be the property of the bankrupt and continue to be subject to the existing security interests. This includes monies realized through the efforts of the Trustee. (*Holy Rosary Parish (Thorold) Credit Union Limited v. The Premier Trust Company*, (1965), S.C.R. 503); *Re Stadnik (Bankrupt)* (1991), 90 Sask. R. 12 (QB); *Re Moore (Bankrupt)* (1989), 79 Sask. R. 63 (C.A.).

- Page 30 -

[125] Counsel to the Trustee submits that the conclusion of the court in *Re ASI Acoustical* is consistent with a long line of jurisprudence that holds that monies recovered by the trustee are subject to the rights of secured creditors.

[126] It seems to me that this statement is too broad. In my view, the focus has to be on whether or not the secured creditor had rights in the collateral at the time of the suspect transaction.

[127] In *Re Yagerphone*, the debenture holder's security was floating and the debenture holder had no claim to the assets recovered by the liquidation.

[128] In *Mohawk*, the floating charge had not crystallized.

[129] In *Maybank*, the court recognized that the secured creditor could have a claim, under a crystallized charge.

[130] In *S-Marque*, the secured creditor held a floating charge and the preference "occurred before the debenture crystallized".

[131] In *ASI Acoustical*, the court concluded that it was open to the registrar to conclude that the settlement monies were accounts receivable and subject to the security interest.

[132] In *Agricultural Credit Corp.*, monies owing to a bankrupt on account of shares in the Saskatchewan Wheat Pool, when collected by the trustee continued to be the property of the bankrupt and subject to the existing security interest. It was not a preference action.

[133] *Re Yagerphone* arose in the context of a regime dominated by fixed and floating charge debentures. In Ontario, since the enactment of the *Personal Property Security Act*, R.S.O. 1990, c. P-10 ("*PPSA*"), security agreements do not generally refer to fixed and floating security, but the concepts of fixed and floating charges is still recognized. (See *Bank of Montreal v. Innovation Credit Union*, *supra*.)

[134] Under the *PPSA* regime, the issue that has to be analyzed is whether or not the debtor had the ability to transfer the collateral charged by the security agreement to a third party free and clear of the security interest.

[135] It seems to me that, if the debtor was in a position to transfer the collateral free and clear of the interest of the secured party, the *Re Yagerphone* analysis and conclusions remain valid. Conversely, if the collateral remains subject to the claims of a secured party, the secured party may retain the ability to enforce its rights as against the collateral or any proceeds arising from the collateral.

[136] It seems to me that this outcome is consistent with the views of Doyle C.J. in *Fresjac Pty. Ltd. (In liq), Re, supra*, which are summarized at [86] – [88] above. I am in agreement with the views and conclusions set out by Doyle C.J. in that case. The outcome is also consistent with the approach of Lee Eng Beng in the emphasized part of [95]. The outcome is also consistent with the approach outlined by Gerald McCormack at [96] and by Nancy Sanborn at [97].

- Page 31 -

[137] Section 95 of the *BIA* makes it clear that a transaction that is declared to be a preference is void as against the trustee. This, in my view, makes it clear that it is the trustee that has the cause of action to declare a preference to be void. But, as stated in *Fresjac Pty. Ltd. (In Lq.)*, *Re supra*, the issue of who possesses the right to bring a preference action does not necessarily determine entitlement to proceeds.

[138] The s. 95 cause of action remedy is designed to ensure that there is *pari passu* treatment as between unsecured creditors. The recipient of a preferential transfer is not entitled to keep the preferential proceeds if the elements of s. 95 are proven. The subject of the preference is returned to the estate but subject to the rights of secured creditors. In the words of Lee Eng Beng at [95] above, "...if a secured creditor has the right to recover the assets transferred away in breach of his security rights and the liquidator or trustee in bankruptcy recovers the assets pursuant to the statutory provisions, any recovery by the latter must be held for the benefit of the former in so far as they would have been recoverable by the secured creditor."

[139] Ultimately, distributions of the bankrupt's estate are made pursuant to s. 136 of the *BIA* and again are preferred with the *proviso*: "subject to the rights of secured creditors".

[140] The ability of a trustee to recover monies for the estate for the benefit of creditors is, in its entirety, subject to the rights of secured creditors. If a secured creditor still has rights in the collateral, there is nothing in the fraudulent preference remedy regime that would appear to preclude the secured creditor from exercising its rights. To the extent that the secured party has rights in the collateral and has a remedy against the collateral in the hands of the third party, such remedy and the resulting priority is not, in my view, altered because a trustee embarks on a preference action.

[141] This analysis is consistent, in my view, with the structure of the *BIA*. The *BIA* respects the rights of secured creditors. Over time, modifications have been made to the statute to harmonize it with statutes providing for remedies to secured creditors. But, the priority regime has not changed. If the secured creditor has rights to the collateral, the secured creditor takes priority over the claims of unsecured creditors.

[142] Counsel to the Trustee also referenced *Re Thorne Ernst & Whinney and Gazzola et al.* in connection with an explanation as to the interplay of the preference provisions and priority distributions. The case involved a dispute between a landlord of a bankrupt tenant and the trustee. The landlord appealed from a judgment holding that a distress levied by the landlord was fraudulent and void as a preference as against the lessee's trustee.

[143] Justice Hickson opined that under the *BIA*, the trustee is charged with gathering the assets of the bankrupt for the benefit of the creditors and then distributing those assets pursuant to the scheme of distribution set out in s. 136 of the Act. In the context of a preference, the trustee can bring an application under s. 95 and, if successful, the landlord would be required to pay over the proceeds of the transaction to the trustee. Hickson J.A. went on to state that "in due course, depending on the claims of secured creditors and those standing in priority to the landlord under the scheme of distribution established by s. 136 of the Act, if there are sufficient assets in the estate the landlord will then receive payment pursuant to the provisions of that section".

- Page 32 -

[144] Counsel to the Trustee went on to submit that in a similar case involving a preference action against the landlord, the Court of Appeal for Ontario considered and followed *Gazzola* and, citing concurring reasons in *Gazzola*, the court noted that the preference proceeds are to be distributed in accordance with the scheme in s. 136, which is subject to the rights of secured creditors: See *Canadian Imperial Bank of Commerce v. Canotek Development Corp.*, *supra*.

[145] In reviewing both the *Gazzola* decision and the *Canotek* decision, I do not see any finding that it is inconsistent with the views that I have expressed above. Simply put, a trustee can pursue a preference action. If the trustee recovers proceeds, they are to be distributed in accordance with s. 136. The reference "which is subject to the rights of secured creditors" restates the position that if secured creditors have rights in the collateral, such priority is to be respected by the trustee.

[146] I do not read into the words "subject to the rights of secured creditors" as putting the position of the secured creditor at an even higher level. Specifically, I do not interpret this phrase as enabling a secured party to step into and occupy the position of the trustee. The trustee's rights are established under the *BIA*. The rights of a secured creditor are provided for in security agreements and the *PPSA* and the process by which realization takes place is provided for in court orders, security agreements, the *PPSA*, and in this case, the *BIA*.

[147] Counsel to the Trustee also raises a number of policy considerations underlying the *BIA* in support of its position. Specifically, counsel submits that the proposition that unsecured creditors have priority to the proceeds of a preference action may lead to anomalous results insofar as an insolvent person could defeat the rights of a secured creditor by simply granting a preference immediately prior to assigning itself into bankruptcy. The consequences of reversing the preference would be such that the proceeds would benefit unsecured creditors. Counsel submits that it cannot be correct that by dealing with collateral in a preferential fashion, an insolvent person can alter bankruptcy priorities and nullify a secured creditor's exclusive claim to that collateral.

[148] This theme has also been recognized in certain academic writings. For example, Professor Fletcher, in *The Law of Insolvency*, provides support for the trustee's position. In stating that the purpose of a preference action is to restore the situation to the *status quo ante*, he puts into doubt the notion that the proceeds of the action are not subject to the rights of secured creditors.

[149] The answer to the concern posed by counsel to the Trustee is not easy. To some extent, secured creditors are protected by an ability to take action for recovery as a result of the provisions of their particular security agreement. The *BIA* does not extinguish the rights of secured creditors to follow collateral if circumstances are such that it is lawful and appropriate to follow the collateral.

[150] If, for example, the transaction is out of the ordinary course of business or, if the recipient is on notice that it is an improper transaction, the secured party may very well have rights to recover the collateral or proceeds. However, if the debtor was in a position to lawfully dispose of the collateral free and clear of the security interest, and has done so, it could very well be that the only recovery for the secured creditor would be to participate in a distribution to

- Page 33 -

unsecured creditors under s. 136 of the *BIA*. This, of course, would happen if the secured creditor declares part of its indebtedness to be unsecured. This outcome is a consequence, however, not of some realignment or readjustment of priorities under the *BIA*, but rather, it is a consequence of a factual scenario under which the debtor could lawfully transfer the collateral. This outcome is, in my view, consistent with the *Yagerphone* analysis.

[151] In the final analysis, I have concluded that:

- (i) a trustee in bankruptcy (or a section 38 *BIA* assignee) is the only party that can bring a preference action in bankruptcy proceedings;
- (ii) the proceeds recovered by the trustee are brought into the estate;
- (iii) distribution under the *BIA* is subject to the rights of recovery of secured creditors;
- (iv) the bringing of a preference action and the recovery of proceeds does not preclude secured creditors from pursuing whatever remedies they may have under the provisions of the security agreement and relevant statutes.

[152] There is also nothing, in my view, that would preclude a secured creditor from pursuing appropriate remedies in conjunction with the trustee pursuing its remedies. For example, at the outset of a proceeding, when investigations may not have been complete, it may be difficult to pinpoint a specific remedy. This would likely require a cooperative effort as between secured creditors and a trustee and some sort of formal agreement to recognize how matters are to be prosecuted and how proceeds of litigation are to be allocated. An example of such an arrangement is referenced in *Re Sharpland Inc., supra*.

[153] Overall, the objective of the preference action is to void preferential transactions for the benefit of creditors, while recognizing legitimate security interests.

[154] Air Canada has taken issue with the role of the Trustee in this case and makes specific reference to s. 13.4 of the *BIA* which explicitly contemplates that a trustee may act for or assist a secured creditor in certain circumstances. These submissions from counsel to Air Canada have been put forth in an effort to persuade the court that the Trustee should, in this case, be following the requirements of the *BIA*. Counsel to Air Canada also questions whether this court has the jurisdiction to allow a trustee to pursue a *BIA* preference action within the context of a *CCAA* proceeding.

[155] The *CCAA* does address the issue of preferences and transfers under value. Section 36.1(1) provides that the preferential provisions of the *BIA* apply, with any modifications that the circumstances require, in respect of a compromise or arrangement, unless the compromise or arrangement provides otherwise.

[156] In this case, there is no compromise or arrangement that has been proposed to creditors, nor is it expected to flow from the type of proceeding that is currently before the court.

[157] This leads to a straight-forward conclusion, in my view, that the preference action should proceed under the *BIA*.

[158] However, this conclusion leads to the subject of coordination of proceedings under the *CCAA* and the *BIA*. This subject was addressed by the Supreme Court of Canada in *Century Services Inc. v. Canada (Attorney General)*, [2010] 3 S.C.R. 379.

[159] In *Century Services*, the majority noted that the *CCAA* is a flexible statute designed to preserve the value of a business as a going-concern through a court supervised re-organization. In that case, a re-organization under the *CCAA* had failed and the Crown brought a motion for payment of its statutory deemed trusts pursuant to s. 222(3) of the *Excise Tax Act*, R.S.C. 1985, c. E-15. Brenner C.J. denied the motion and allowed the assignment of the company into bankruptcy. The British Columbia Court of Appeal had found that while the Crown could not seek repayment of GST source deductions in priority to other claims during a *CCAA* or *BIA* proceeding, it could do so after the reorganization efforts had failed and prior to the commencement of a *BIA* proceeding, such that the trial judge was bound to allow the motion and apply the provisions of the *Excise Tax Act*. The majority of the Supreme Court rejected this reasoning noting at para. 47 that an interpretation giving the *Excise Tax Act* priority over the *CCAA* would result in a “strange asymmetry” which would encourage statute shopping.

[160] Justice Deschamps, writing for the majority, rejected the contention that Brenner C.J. had exceeded his authority by continuing the stay of the Crown’s GST claims while temporarily lifting the general stay to allow for the assignment in bankruptcy. Section 11 of the *CCAA*, subject to certain restrictions, provides the court with broad authority to make an order that is appropriate in the circumstances – a power which is not subject to explicit temporal limitations and is buttressed by the court’s inherent jurisdiction, as well as s. 20 (now s. 42) of the *CCAA*.

[161] At para. 76 of *Century Services*, it is noted that the *CCAA*’s objectives permit for a bridge between the *CCAA* and *BIA* proceedings. As recently noted by the Supreme Court of Canada regarding section 20 of the *CCAA*:

That section provides that the *CCAA* “may be applied together with the provisions of any Act of Parliament ... that authorizes or makes provision for the sanction of compromises or arrangements between a company and its shareholders or any class of them”, such as the *BIA*. Section 20 clearly indicates the intention of Parliament for the *CCAA* to operate in tandem with other insolvency legislation, such as the *BIA*.

[162] Further, Deschamps J. wrote at para. 78:

Tysoe J.A. therefore erred in my view by treating the *CCAA* and the *BIA* as distinct regimes subject to a temporal gap between the two, rather than as forming part of an integrated body of insolvency law. Parliament’s decision to maintain two statutory schemes for reorganization, the *BIA* and the *CCAA*, reflects the reality that reorganizations of differing complexity require different legal mechanisms. By contrast, only one statutory scheme has been found to be needed to liquidate a bankrupt debtor’s estate. The transition from the *CCAA* to the *BIA* may require the partial lifting of a stay of proceedings under the *CCAA* to allow commencement of the *BIA* proceedings. However, as Laskin J.A. for the Ontario Court of Appeal noted in a similar competition between secured creditors and the

- Page 35 -

Ontario Superintendent of Financial Services seeking to enforce a deemed trust, “[t]he two statutes are related” and no “gap” exists between the two statutes which would allow the enforcement of property interests at the conclusion of *CCAA* proceedings that would be lost in bankruptcy.

[163] This passage from *Century Services* clearly states, in my view, that the courts should be taking a pragmatic approach in determining issues which arise in proceedings where the *CCAA* overlaps with the *BIA*. This is one such proceeding. The overall objective should be to create a system under which the court can review transactions entered into between the debtor and creditors in the period just prior to formal insolvency proceedings. The policy should be to ensure that there is an appropriate review mechanism in place to challenge transactions that are not consistent with ordinary course activities and have had the effect of unfairly transferring value to a third party during the review period. It seems to me that the *CCAA* can operate in tandem with the *BIA* in an effort to return matters to the *status quo*.

[164] Applying the principles of *Century Services*, it seems to me, that the preference motion should proceed in the *BIA* proceedings. However, in my view, this can be accomplished by a procedural order in *CCAA* proceedings which transitions the matter to the *BIA*. There is no necessity or principled reasons to require the trustee to start from square one. This outcome is consistent with my endorsement of February 24, 2010 at paras. 29 – 32.

[165] It is also appropriate, at this time, and in view of the contemplated continuation of the preference motion, that proceedings be regularized with the Trustee taking the necessary steps to comply with its obligation under the *BIA*.

DISPOSITION

[166] In the result, a declaration shall issue to incorporate the conclusions set out at [151] which, for ease of reference, is repeated:

- (i) a trustee in bankruptcy (or a Section 38 *BIA* assignee) is the only party that can bring a preference action in bankruptcy proceedings;
- (ii) the proceeds recovered by the trustee are brought into the estate;
- (iii) distribution under the *BIA* is subject to the rights of recovery of secured creditors;
- (iv) the bringing of a preference action and the recovery of proceeds does not preclude secured creditors from pursuing whatever remedies they may have under the provisions of the security agreement and relevant statutes.

[167] I have also concluded that, if it is determined that the transaction is void as being a preference, at that point, the appropriate determination can be made as to which party, be it either the trustee or the secured party, is entitled to the proceeds. This determination should be based on whether the secured party has the right to recover the assets transferred, or any proceeds resulting from such transfer. In my view, it is premature to comment on this issue, in the circumstances of this case, as the factual record has not been fully determined.

- Page 36 -

[168] In the context of this particular case, if it is the intention of the secured party to work in conjunction with the Trustee and for the Trustee to utilize the preference provisions, the appropriate notifications should be provided in accordance with s. 13.4 of the *BLA* and the Trustee should move forward to fulfill its statutory obligations in the conduct of its administration.

[169] To the extent that further directions are required in respect of this endorsement, the parties may contact the Commercial List Office to set up a 9:30 a.m. appointment.



MORAWETZ J.

Date: August 18, 2011