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• CRYPTOCURRENCY ASSETS UNDER INSOLVENCY AND PERSONAL PROPERTY SECURITY LAW •

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• In This Issue •

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Encrypted digital currencies ("cryptocurrencies"),[1] particularly Bitcoin, have recently become the target of enormous international speculation and market scrutiny. Some expect cryptocurrency payments and other transactions tracked via distributed ledger technology ("DLT", of which "blockchain" technology is one example) to be the future of commercial interaction. The theory is that cryptocurrencies could become "the holy grail of commerce — a payment system that would eliminate or minimize the roles of third party intermediaries".[2]

Is Canadian commercial law ready for this brave new world? Specifically, how do the laws governing debtor-creditor relationships apply to cryptocurrencies?

This article discusses the legal characterization of cryptocurrency units ("tokens"), their utility as a commercial payment medium given current Canadian personal property security law, and, in light of several high-profile insolvencies of the platforms on which cryptocurrencies are traded ("exchanges"), the treatment of tokens in insolvency scenarios. It considers the following questions:

- Does Canadian law treat digital currencies as cash, commodities or something else?
- Can a lender take security over a borrower's cryptocurrency assets — and if so, can a third party

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accept a payment in tokens free and clear of the lender's security interest?
- If a token exchange or wallet provider enters insolvency proceedings, does a tokenholder have a creditor claim or a property claim in the estate?
- If such a claim is recoverable, will the tokenholder get tokens back or only their pre-filing cash value — which may be considerably lower or higher than the present-day value of the token in a volatile market?
- What challenges does an insolvency professional face in dealing with cryptocurrency assets?

As the term would suggest, cryptocurrencies are designed as payment systems, not simply targets for speculative investment (as Bitcoin is arguably becoming). The high valuations of many cryptocurrencies only make sense if they can one day be exchanged for a range of goods and services, circulating without friction and with finality and certainty.

Unfortunately, North American personal property security law does not treat cryptocurrencies as negotiable instruments, and cryptocurrency assets (or claims against them) can be challenging to realize in insolvency scenarios. Both of these problems obstruct the mainstream adoption of cryptocurrencies as payment systems.

THE LEGAL CHARACTERIZATION OF TOKENS

As Aird & Berlis partner Donald B. Johnston has written, the legal characterization of cryptocurrency tokens is controversial, unsettled and variable by jurisdiction.[3]

Many cryptocurrencies, as the term suggests, are designed to function as digital currency or money. But is a token *money*? Is it even the holder's *personal property* at all?

The Canada Revenue Agency characterizes[4] cryptocurrencies as commodities rather than currency for tax purposes and applies the so-called "barter rules" to transactions in cryptocurrencies. Indeed, at the moment, a commodity like gold is a reasonable analogy to a cryptocurrency like Bitcoin; it is "mined", it is used as a target of speculation, and tokens, like

gold certificates or gold itself, are somewhat fungible and occasionally used for commercial payments.

A Bank of Canada position paper[5] expressed a similar viewpoint in 2014, positing that no form of cryptocurrency had, at that time, the essential qualities that are ascribed to money; (i) a medium of exchange, (ii) a unit of account and (iii) a stable store of value. Despite Bitcoin's price spike, this analysis still rings true.

Personal property security law in Canada (and its analogous legislation in the U.S.), as currently constituted, does not include tokens in the definition of "money", but rather treats them as "intangibles", a classification that severely restricts their utility as a mainstream payment medium and as an asset that can easily be made the subject of a security interest.

Other jurisdictions may differ significantly in their legal characterization of tokens. Indeed, a Japanese court has held that, under Japan's Civil Code, tokens are not capable of personal ownership at all — a holding that had significant implications for creditors in an insolvency proceeding, as this article discusses subsequently.

SECURED TRANSACTION ISSUES — THE "ACHILLES HEEL" OF CRYPTOCURRENCY ADOPTION?

Currently, there is no administrative guidance or case law that specifies how cryptocurrency tokens should be treated for the purposes of Canadian personal property legislation (in each common-law province, the "PPSA"). No PPSA has yet added definitions or collateral classifications that directly reference cryptocurrency assets.[6] Under the current definitions in the PPSA, a cryptocurrency token held directly by its owner would fall into the catch-all category of "intangible". The definitions under the U.S.' *Uniform Commercial Code* ("UCC") are similar and point to the same conclusion.[7]

As currently defined, cryptocurrency tokens would not qualify as "money." Money is a defined term under the PPSA, referring to a medium of exchange adopted by a government as part of a country's currency.[8] (Interestingly, this suggests that if a nation nominally adopted Bitcoin as an official form of legal tender, the treatment of cryptocurrency assets under personal property security law could shift dramatically.)

Similarly, unless a court were to find that the "distributed ledger" entry underlying the token constitutes "writing" for the purpose of the *Bills of Exchange Act* (Canada) or the PPSA, which seems unlikely, a token could not be "chattel paper" or an "instrument". It is possible to register shares of companies on the blockchain, as Mr. Johnston discusses in another recent article.[9] In such a circumstance, the PPSA's rules on uncertificated securities would likely apply.[10] However, as tokens do not meet the definition of "security" in the *Securities Transfer Act*, they are not "investment property".[11] By process of elimination then, tokens should likely be categorized as "intangibles."

This definitional question has commercial consequences. Intangibles are described as "the least negotiable of all UCC [and PPSA] forms of property".[12]

The PPSA allows money, cheques and other negotiable instruments to circulate free and clear of security interests.[13] The public policy behind this rule is obvious. Similarly, purchasers of goods, chattel paper, instruments and some other categories of collateral are able to take the purchased item free and clear of a security interest if the transaction is made in the ordinary course of business, with or without knowledge of the security interest.[14] (This was also the rule in section 2 of the old Ontario *Factors Act*, which predates the PPSA.) Under the PPSA (and UCC), purchasers of intangibles have no such protections.

So, suppose a debtor has granted to a lender a security interest over all its present and after-acquired property (a common practice) — including, of course, intangibles. If the debtor then pays a third party with a token to which the lender's security has attached, the lender has a superior claim to the token as against the third party payee. DLT makes these payments almost infinitely traceable on a public register, accessible by anyone with the correct software and know-how.

This is obviously a problem for recipients of cryptocurrency payments — no third party would responsibly accept a payment that could be clawed back by the payor's secured creditor at any time.

For these reasons, some commentators have described the existing North American personal property security regime as an "Achilles heel" for the future of cryptocurrencies — at least for their utility as payment systems as opposed to commodities or targets of speculation.[15]

ARE TOKENHOLDERS PROTECTED IN INSOLVENCY?

Cryptocurrency deposits, unlike most Canadian bank deposits, are not insured. And, as noted above, the position of secured creditors in relation to tokens is uncertain. Blockchain technology adds further practical challenges, not to mention a steep learning curve for insolvency professionals and their consultants. As a result, it is difficult to predict outcomes in insolvency scenarios, a state of play that makes it difficult to imagine sophisticated commercial players doing business entirely in digital currencies, or investing in companies that do so.

Recent high-profile insolvencies of cryptocurrency exchanges show that these concerns are not simply theoretical. Fraud, theft and cybersecurity continue to be live issues in the space.

There have been some very public examples. In 2014, the largest bitcoin exchange at the time, Mt Gox, filed for bankruptcy[16] after hackers allegedly misappropriated US$467.5 million worth of bitcoin. The bankruptcy trustee of Mt Gox was able to obtain an order from the Ontario Superior Court of Justice recognizing the Mt Gox bankruptcy proceedings in Japan. Cryptsy, a U.S.-based exchange, was placed into a court-appointed receivership by certain Cryptsy users in May of 2016, amid allegations of fraud and misappropriation of tokens by the exchange's founder.[17] A South Korean exchange, YouBit, declared bankruptcy in December 2017 after another bitcoin heist, this time with North Korea allegedly implicated in the theft.[18]

An interesting question in any insolvency scenario involving an exchange is whether tokenholders can expect a proprietary remedy in tokens, or merely an unsecured creditor claim for the cash value of the tokens at the time of insolvency.

This question was at issue in the Mt Gox proceedings. A former exchange customer brought a lawsuit against the trustee seeking a return of the bitcoins that Mt Gox held on its behalf. The Tokyo District Court held that under the applicable provisions of Japan's Civil Code, the creditor did not (and could not) have proprietary ownership in the bitcoin on deposit (which would lead to recovery of the tokens themselves, *in specie*). The creditor instead only had a contractual right to the return of the value of the tokens (provable as an unsecured debt in bankruptcy).

Since no proprietary claims were possible, the creditor claims of Mt Gox tokenholders were valued at approximately US$438, the pre-filing value of bitcoin. Not only did the price of bitcoin subsequently skyrocket, but the trustee was able to recover approximately 202,185 of the supposedly-stolen bitcoins, at that time worth almost $2 billion. The subsequent bitcoin price spike resulted in the value of the estate's assets vastly exceeding total claims of its creditors, a surplus that could result in a multi-billion dollar windfall for the majority shareholder of Mt Gox, despite his alleged acts having caused the loss in the first place (although this is not to say that such windfall could not eventually be accessed by Mt Gox tokenholders by way of a personal claim).

As a result, some Mt Gox creditors have sought a conversion of the bankruptcy proceeding into "civil rehabilitation" (essentially, Japan's analogue to the *Companies' Creditors Arrangement Act* or Chapter 11) that could result in a plan of compromise by which creditors could recover a *pro-rata* share of their original holdings in the form of bitcoin rather than yen, allowing them to benefit from the massive appreciation in bitcoin value post-filing, as opposed to recovering an amount in yen that is capped at the pre-filing value of bitcoin.[19]

The Mt Gox situation should not imply that tokenholders can *never* assert a proprietary claim to tokens deposited in an exchange. As Japanese attorney Akihiro Shiba aptly points out in an article for trade publication Coindesk in which he discussed the implications of the case under Japanese law, the "ownability" of bitcoins could be decided differently

under Japanese law if the tokenholder's "private key" were controlled and managed by the customer (in the Mt Gox scenario, Mt Gox managed tokenholders' private keys). Outcomes would vary according to the facts and to the jurisdiction in which the issue was heard.

Whether under the Japanese Civil Code or otherwise, there may be future cases in which tokenholders will be able to assert a trust or other proprietary remedy to recover, in full, their tokens held on a third-party exchange — it would depend on the structure of the relationship between the user and the platform and how the courts choose to characterize that relationship.

CHALLENGES FOR INSOLVENCY PROFESSIONALS

Most insolvency professionals are familiar with the vagaries of tracing and recovering traditional currencies. However, digital currencies create even more complex issues for insolvency professionals.

At the outset of a mandate, bringing assets under control presents a significant challenge. Even if a debtor's anonymous "public key" could be determined (which would allow for the debtor's transactions on the distributed ledger to be followed), the debtor's cooperation would be required in order for a receiver or trustee to obtain and use the debtor's "private key" and thus control the assets. Many tokenholders wisely opt to store their digital credentials offline and in secure areas. In some extreme cases, tokenholders with significant holdings are apparently storing their "private key" on an offline computer locked underground in a decommissioned Swiss military bunker due to security concerns.[20] Further, although DLT is intended to ensure the integrity and traceability of assets, the preponderance of fraud and hacking in this area, as seen in the "loss" of over 2 million tokens in the Mt Gox scenario, suggests that the integrity of the system may not be guaranteed.

The Cryptsy receivership illustrates the practical difficulties of recovering assets — a process described by the receiver as "lengthy and tedious " in its fourth report to court, and detailed in the report as follows:

(i) Cryptsy had an entire array of servers running the wallets and syncing block chains, as well as a team of employees that maintained smooth operation of the wallets; (ii) there are numerous wallets containing different alternative coins that are under my control; (iii) each alternative coin wallet requires its own unique software to run its own block chain; (iv) the receivership estate has billions of individual alternate coins under its control, each coin has its own block chain, and the entire block chain history needs to be linked with the recovered wallets in order to verify the current balance of coins in that wallet; and (v) due to the fact that Cryptsy was an exchange, each wallet contains hundreds of thousands of entries for transactions, and in many cases, the wallets have become corrupted, clogged and unresponsive, requiring more time and effort to recover remaining coins in that wallet.[21]

In addition to these hair-raising technological challenges, Cryptsy's founder attempted to obfuscate or dissipate the assets (destroying servers, starting up a new exchange in China, buying diamond rings and houses with $USD derived from Cryptsy tokens, and other such roguery). To recover assets, the cooperation of dozens of international non-parties (coin exchanges, banks, etc.) was required.

Even if tokens can be recovered, can they be liquidated? Not all tokens are created equal in terms of discoverability and fungibility. At present, there is a strong market for bitcoin, but there are a great many alternative cryptocurrencies that have low to medium liquidity, and very little demand.[22]

Unwinding fraudulent conveyances and other reviewable transactions is another challenge. The anonymity of the blockchain makes it hard to link a particular transaction to a particular recipient, and unwinding one transaction would be a technical challenge that would affect all subsequent transactions on the same "block", if any.[23]

Cryptocurrencies, by design, are intended to be borderless solutions to payment problems, attracting worldwide users, many of whom are tech-savvy and comfortable organizing themselves online.[24] Resulting insolvencies will likely be international, and the location of the foreign main proceeding (being the jurisdiction where the key court decisions are made, and therefore the jurisdiction where the status of cryptocurrency assets under local law will influence

results the most) may have major implications for creditor recovery. Forum shopping can be expected.

CONCLUSION

DLT is poised to disrupt any number of commercial frameworks, and debtor-creditor law is no exception. As more and more cases of fraudulent behaviour and/or insolvency on cryptocurrency platforms make their way through the world's insolvency systems, it will be of great interest to see how courts and legislators respond. In the interim, the varying legal treatments of property ownership and security interests could be barriers to the adoption of digital currencies as mainstream payment systems.

Canada can take the lead by reforming personal property security law to recognize the negotiability and fungibility of blockchain assets, while also ensuring that insolvency law protects the reasonable expectations of tokenholders and provides a sensible solution to the real possibility of a cryptocurrency crash. One option is a separate collateral classification for tokens; the "control" regime already in place for securities accounts could be an excellent starting point for a regulatory system that allows secured cryptocurrency assets to retain their liquidity and negotiability. Conversely, expanding the definition of "investment property" under the PPSA to potentially include certain cryptocurrencies (perhaps only tokens issued pursuant to a regulated ICO), either through legislative amendment or judicial interpretation, could lead to a similar result.

In any event, there is no doubt that the world is watching closely to see whether cryptocurrencies can become more than a target of speculation and function as the borderless, low-friction payment systems that many of them were intended to become. The treatment of cryptocurrency units under commercial law, in Canada and elsewhere, will be crucial to the ultimate outcome.

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1 Terms such as "cryptocurrency," "bitcoin," "blockchain" and "token" are industry jargon, so some notes on terminology follow. Johnston has written a helpful article explaining the "blockchain" as a type of "distributed ledger technology" that provides "a bullet-proof record of proven transactions that everybody (with the appropriate software) can check": see Johnston, Donald B., "What is the Law of the Blockchain?" (March 10, 2016), online: Aird & Berlis LLP <http://www.airdberlis.com/insights/blogs/thespotlight/post/ts-item/what-is-the-law-of-the-blockchain>. Bitcoin and other cryptocurrency providers offer digital payment methods that operate via DLT, as another article of Johnston's describes: see Johnston, Donald B., "Digital Currencies" (May 6, 2016), online: Aird & Berlis LLP <http://www.airdberlis.com/insights/blogs/startupsource/post/ss-item/digital-currencies>. An individual unit of Bitcoin currency is called a bitcoin. An individual unit of digital currency on the Ripple platform (Ripple is currently second to Bitcoin in market penetration) is "XRP". This article refers to individual cryptocurrency units as "bitcoins" if specific reference is being made to the Bitcoin platform or, if reference is made to units of cryptocurrency in general, as "tokens".

2 Schroeder, Jeanne L., "Bitcoin and the Uniform Commercial Code" (August 22, 2015). Cardozo Legal Studies Research Paper No. 458, at p. 3. Available at SSRN: https://ssrn.com/abstract=2649441 or http://dx.doi.org/10.2139/ssrn.2649441.

3 Johnston, Donald B., "Digital Currencies", (May 6, 2016), online: Aird & Berlis LLP <http://www.airdberlis.com/insights/blogs/startupsource/post/ss-item/digital-currencies>.

4 Canada Revenue Agency Fact Sheets, "What You Should Know About Digital Currency" (December 3, 2014), online: Government of Canada <https://www.canada.ca/en/revenue-agency/news/newsroom/fact-

sheets/fact-sheets-2013/what-you-should-know-about-digital-currency.html>.

[5] Bank of Canada, "Decentralized E-Money (Bitcoin)" (April 2014), online: Bank of Canada <http://www.bankofcanada.ca/wp-content/uploads/2014/04/Decentralize-E-Money.pdf>.

[6] On this issue, the PPSAs in each province are fundamentally similar. Article 9 of the *Uniform Commercial Code* is similarly structured, so the conclusion in this article — that cryptocurrencies are intangibles for the purpose of personal property security legislation — would likely also apply in the U.S. For a detailed analysis in the U.S. context, see Schroeder, *supra* note 4.

[7] Schroeder, *supra* note 4 at para. 5.

[8] *Personal Property Security Act*, R.S.O. 1990, c. P.10, s. 1(1).

[9] Johnston, Donald B., "How Blockchains Will Change Stockholder Democracy" (December 14, 2017), online: Aird & Berlis LLP <http://www.airdberlis.com/insights/blogs/TheSpotlight/post/ts-item/how-blockchains-will-change-stockholder-democracy>.

[10] From a policy perspective, the rules applicable to uncertificated securities (see s. 30.1 of the PPSA — the party with control of the tokens would have priority over a security interest of a secured party that does not have control of the tokens) may be the best way to accurately capture and support how blockchain assets currently circulate, particularly since control can exist by way of a third-party intermediary (in the investment property regime, a "securities intermediary" *i.e.*, a broker; with Bitcoin, the wallet provider or exchange). This makes them freely tradeable, as the party controlling the tokens, even through a wallet provider, is assured of priority in most cases.

[11] It is arguable, however, that tokens issued pursuant to an "initial coin offering", or "ICO" and held by a third-party exchange could qualify as "investment property" under the PPSA definition if the ICO was lawfully regulated by a securities regulator. In this case, again, the tokens would be subject to the control regime described in the immediately preceding footnote.

[12] Schroeder, *supra* note 3 at para. 12.

[13] *Personal Property Security Act*, R.S.O. 1990, c. P.10, s. 29.

[14] *Ibid*, s. 28.

[15] Lawless, Bob, "Is UCC Article 9 the Achilles Heel of Bitcoin?" (March 10, 2014), online: Credit Slips <http://www.creditslips.org/creditslips/2014/03/is-ucc-article-9-the-achilles-heel-of-bitcoin.html>. Again, the control regime applicable to certificated and uncertificated securities could be a solution.

[16] Mt Gox Bankruptcy Trustee Press Release (May 25, 2016), online: Mt Gox <https://www.mtgox.com/>.

[17] Case website of James D. Sallah, Court-Appointed Receiver for Project Investors, Inc. d/b/a Cryptsy, online: Cryptsy Receivership <http://cryptsyreceivership.com/>. See also Cryptsy Cryptocurrency Class Action Settlement Notice, online: Cryptsy Settlement <http://www.cryptsysettlement.com/>.

[18] Gallagher, Sean, "North Korea suspected in latest bitcoin heist, bankrupting Youbit exchange" (December 20, 2017), online: Ars Technica <https://arstechnica.com/tech-policy/2017/12/north-korea-suspected-in-latest-bitcoin-heist-bankrupting-youbit-exchange/>.

[19] Meyer, David, "After Bitcoin Spike, MtGox Creditors Want to Yank the Failed Exchange Out of Bankruptcy" (December 13, 2017), online: Fortune <http://fortune.com/2017/12/13/bitcoin-mtgox-bankruptcy-creditors/>.

[20] Wong, Joon Ian "Switzerland's bitcoin bunker" (November 29, 2017), online: Quartz Media LLC <https://qz.com/email/quartz-obsession/1130471/>.

[21] Fourth Report of James D. Sallah, Court-Appointed Receiver for Project Investors, Inc. d/b/a Cryptsy, online: Cryptsy Receivership <http://cryptsyreceivership.com/v1/wp-content/uploads/2016/06/Fourth-Report.pdf>.

[22] *Ibid*., at para. 9.

[23] For details on the technical aspects of this process from the standpoint of the insolvency professional, see Møller, Charlotte & Claude Brown, "Insolvency of Virtual Currencies – a New Reality?" (June 2017), online: ReedSmith <https://www.reedsmith.com/en/perspectives/2017/06/insolvency-of-virtual-currencies-a-new-reality>.

[24] Cryptocurrency aficionados often frequent online forums such as Reddit. This can lead to highly organized, and highly disruptive, creditor committees. See, for example, the Subreddit for the Mt Gox proceedings, where tokenholders from all over the globe worked together to "crowdfund" litigation efforts, hire a Japanese representative counsel, and discuss legal issues — it is a fascinating, real-time insight into the workings of an organically-formed "creditors committee". See < https://www.reddit.com/r/mtgoxinsolvency/ >.

• ENFORCEABILITY OF A SECURITY DEPOSIT AGAINST A TRUSTEE IN THE EVENT OF THE BANKRUPTCY OF A COMMERCIAL TENANT •

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When negotiating a commercial lease, it is in the landlord's best interest to require that securities be provided by the prospective tenant in order to protect the landlord against the tenant's failure to perform its obligations under the lease. A frequent cause of a tenant's inability to perform its obligations is its insolvency or financial difficulties. It is important for landlords to know that the tenant's bankruptcy, or the filing by the tenant of a notice of intention or a proposal under the *Bankruptcy and Insolvency Act* (the "**BIA**") can have the effect of negating the protection afforded by certain forms of security.

This article concerns in particular a security frequently required by landlords, namely the remittance by the tenant of a sum of money that may be equivalent to one or more monthly instalments of rent, which is sometimes referred to in leases either as a "security deposit", or as "prepaid rent". We will see that in the event of the tenant's bankruptcy, notice of intention or proposal under the BIA, depending on the wording of the clause in the lease dealing with the deposit, the landlord may be obliged to remit the amount of the deposit to the trustee, even if the tenant is indebted towards the landlord.

The problem stems from the fact that in the case of a bankruptcy, a notice of intention or a proposal under the BIA, the hypothecs granted by the tenant in favour of a commercial landlord are not enforceable against the trustee.

Indeed, the Court of Appeal of Quebec in the *Ocean Drive*[1] decision concluded that a landlord, who is granted a preferred creditor status by Section 136(1)(f) of the BIA, must necessarily be collocated at the rank provided by said section, and cannot benefit from the priority provided in the *Civil Code of Québec* ("**CCQ**") because of the doctrine of paramountcy which establishes that federal law prevails over provincial law when there is a conflict between them:

> [TRANSLATION] *"It must be concluded that the status of secured creditor claimed by the landlord on account of its conventional movable hypothec would change the order of priority assigned to landlords by Section 136(1)(f) of the BIA, by improving the priority of rank of the preferred claim expressly covered by that section. Consequently, the provisions of the Civil Code on prior claims and hypothecs that would otherwise affect the order of priority under the BIA by giving the landlord the status of a "secured creditor" are inapplicable in a bankruptcy situation."* [2]

Consequently, in the event of a tenant's bankruptcy, notice of intention or proposal under the BIA, the landlord cannot enforce any hypothec it holds on the insolvent tenant's assets, and must content itself with

the priority of rank provided by Section 136(1)(f) of the BIA, which priority is nevertheless subject to the rights of secured creditors and is limited to the amount realized from the assets in the leased premises.

In the province of Quebec, a deposit granted by a tenant to guarantee the performance of its obligations under the lease constitutes a movable hypothec with delivery, also known as a "pledge".

In order to be enforceable against third parties, a pledge does not need to be published in the *Register of Personal and Movable Real Rights*. A pledge is constituted by physical delivery of the property or title to the creditor or, if the property is already under the detention of the creditor, by the latter continuing such detention, with the grantor's consent, in order to secure the creditor's claim[3]. Thus, the physical delivery of movable property to the creditor and the continued detention of said property by the latter are sufficient to ensure the publicity of the pledge and its enforceability to third parties[4].

We note, however, that some uncertainty exists with regard to a pledge granted on incorporeal (intangible) property as it applies under Article 2702 CCQ since its amendment in 2009. Article 2702 CCQ now requires the "physical" delivery of the property charged by a movable hypothec with delivery. If a claim is incorporeal (intangible), can it be physically delivered? The Court of Appeal addressed this uncertainty in the Basille[5] case in 2014, noting that some authors are of the view that since the 2009 amendment of Article 2702 CCQ, pledging a sum of money is no longer possible because of the incorporeal (intangible) nature of money.[6] However, the Court went on to apply the decision in the Brouillette-Paradis[7] case, which concerned the substitution of a legal hypothec, in which the Court of Appeal accepted that [TRANSLATION] "*the judicial offer to assign, as security, the claim on monies deposited in substitution for a legal hypothec implies the constitution of a movable hypothec with delivery in favor of the holder of the legal hypothec*".[8]

In light of the foregoing, if a deposit remitted to a landlord constitutes a pledge, it is unenforceable against the trustee of a tenant who placed itself under the protection of the BIA. This is what the Court of Appeal decided in *Expleo Global*,[9] where the landlord sued the trustee for occupation rent. In its defence, the trustee admitted to owing the occupation rent, but was requesting the reimbursement of the deposit that the landlord received from the tenant and which the trustee maintained was a pledge. In its analysis on the characterization of the amount remitted to the landlord, the Court took into account that:

- a certified cheque had been given to the landlord as a replacement for the irrevocable and unconditional letter of credit provided for in the lease as security for the performance of the tenant's obligations;
- several of the exhibits, some of which were filed by the landlord, referred to this amount as a "security deposit";
- as at the date of the bankruptcy, the landlord had not yet applied the deposit to the amounts owing by the tenant; and
- no prior notice had been served by the landlord of its intent to realize upon its security before the bankruptcy.

Considering this evidence, the Court was of the opinion that the amount deposited with the landlord could only be considered as a movable hypothec with delivery, even if such security is of lesser value than a letter of credit. The Court added that the deposit in this case could not be considered prepaid rent. Therefore, the security constituted by the deposit was unenforceable against the trustee since the landlord had not availed itself of its right to realize said security before the bankruptcy. The Court therefore concluded that the deposit must be returned to the trustee, for the benefit of the mass of creditors.

However, if the deposit is considered as prepaid rent, it would then be enforceable against the trustee and the landlord would have the right to keep such deposit.

To determine the nature of the deposit provided, the Court must ascertain the intention of the parties to the commercial lease, taking into account the circumstances under which it was concluded, the interpretation the parties have already given it, as well as the other clauses of the lease[10]. Thus, particular attention must be paid to

the wording of the deposit clause, to the other clauses of the lease that refer to this deposit clause, as well as to the behavior of the parties, as the case may be.

In the case of *Ébénisterie Renouveau,*[11] the Superior Court, Bankruptcy Division, had to interpret a "security deposit" clause, where the landlord was claiming rent from the trustee for its occupation of the leased premises following the tenant's bankruptcy. The trustee was contesting the claim, alleging compensation (set-off) of the occupation rent against the amount of the deposit which, the trustee argued, should be paid to it for the benefit of the mass of creditors.

The Court concluded that the parties to the lease had intended that the deposit be non-refundable and that it be applied to future rent or any other amount owing by the tenant in default, despite the fact that the said clause was entitled "security deposit". The main criterion on which the Court based its decision was the non-refundable nature of the deposit. It was actually a partial prepayment of rent which had become the property of the landlord upon payment in May 2005, well before the bankruptcy.

More recently, in the *Alignvest* case,[12]- the Court of Queen's Bench of Alberta had to decide whether the landlord had to pay to the trustee the amount of the deposit which had been remitted to it by the now bankrupt tenant, further to a request by a secured creditor, Alignvest. The clause for the deposit was entitled "Security Deposit/Rent Credit" and provided that the deposit was to be applied towards future rent payments, but only if the tenant was not then in default. Although the clause contained some indication of the parties' intention to consider the deposit as prepaid rent, the Court rather concluded that the deposit constituted a security deposit, as the clause provided that the amount was to be held by the landlord as security for the tenant's performance of its obligations under the lease. The Alberta Court of Appeal confirmed the decision rendered in first instance by the Court of Queen's Bench on the nature of the deposit. It also took into account the fact that the lease provided that the tenant must renew the deposit in the event that the landlord used the deposit to remedy a default by the tenant during the term, which, according to the Court, is incompatible with the notion of prepaid rent.

Considering the above decisions and in order to ensure that the amount remitted to the landlord upon the execution of a commercial lease not be considered as a movable hypothec with delivery and to ensure that it be enforceable against the trustee in the event of a bankruptcy, notice of intention or proposal under the BIA by the tenant, the lease should, in general, provide the following:

- that the amount of the deposit constitutes prepaid rent that becomes the property of the landlord upon disbursement to the landlord at the time of execution of the lease; and
- that the deposit is non-refundable;
- the term "security deposit" should not be used in the lease, nor should the deposit be referred to therein as security for the performance of the tenant's obligations under the lease.

In conclusion, there are two opposing concepts: the security deposit and the prepaid rent. In the event of a dispute, the whole will be a matter of interpretation of the lease and the clause in question, taking into account the intention of the parties.

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1 *Restaurant Ocean Drive inc*. v. *Sam Levy & associés inc*.

2 *Ibid.*

3 Article 2702 CCQ

4 Article 2703 CCQ

5 *Basille* v. *9159-1503 Québec Inc*., [2014] J.Q. no 973, 2014 QCCA 1653.

6 Louis Payette, *Les sûretés réelles dans le Code civil du Québec*, 5th edition, Cowansville, Yvon Blais, 2015, par. 965

7 *Brouillette-Paradis (Paysages Paradis)* v. *Boisvert*, [2009] J.Q. no 8578, 2009 QCCA 1615.

[8] *Ibid.*, par. 28.

[9] *Expleo Global Inc. (Trustee of)*, [2003] Q.J. No. 27562, EYB 2003-39337.

[10] Articles 1425 to 1432 CCQ

[11] *Ébénisterie Renouveau inc. (143301 Canada inc.) (Syndic de)*, [2009] Q.J. No. 2884, 2009 QCCS 1454.

[12] *Alignvest Private Debt Ltd*. v. *Surefire Industries Ltd*, [2015] A.J. No. 316, 2015 ABQB 148 (the characterization of the deposit by the Court of Queen's Bench was confirmed by the Alberta Court of Appeal in *York Realty Inc* v. *Alignvest Private Debt Ltd.*, [2015] A.J. No. 1234, 2015 ABCA 355).

• SCC PROVIDES GUIDANCE ON TRUSTEES' DUTY TO DISCLOSE CONSTRUCTION BONDS TO BENEFICIARIES •

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The Supreme Court of Canada (SCC) ruled in its recent decision, *Valard Construction Ltd. v. Bird Construction Co.,* [2018] S.C.J. No. 8, 2018 SCC 8 (*Valard Construction*), that an "obligee" or trustee under a labour and material payment bond (usually the owner or general contractor) may be required to disclose the bond's existence to its beneficiaries (usually subcontractors).

Prior to this decision, Canadian courts held that an obligee is only required to disclose the existence of a bond in response to a demand for information, such as demands made under applicable builders' lien legislation. From now on, owners and general contractors will need to notify potential claimants of the existence of a bond in certain circumstances.

OVERVIEW

Valard Construction arose out of a claim by a utility sub-subcontractor (Valard) for directional drilling work done and materials provided to an oil sands worksite located near Fort McMurray, Alberta. The electrical subcontractor that engaged Valard became insolvent and some of Valard's invoices went unpaid. Valard later learned of a bond obtained by the electrical subcontractor, which named the general contractor as obligee and the electrical subcontractor as principal, and sought to claim under the bond.

The bond at issue was a standard form CCDC 222-2002 labour and material payment bond, which provides that a beneficiary who has not received payment within 90 days of the last day on which it provided work and/or materials may sue the surety on the bond for the unpaid sum. The beneficiary is required to provide notice to the surety, principal and obligee of its claim within 120 days of the last date that the work and/or materials were provided to the project in order to claim under the bond.

Valard did not learn of the bond until seven months after the 120-day notice period had expired. As a result, the surety denied Valard's claim. Valard then commenced a claim against the general contractor for the amount it would have claimed under the bond.

SCC Decision

The majority of the SCC found that the general contractor was liable to Valard for the sum that it could have obtained under the terms of the bond, had it been aware of its rights.

According to the SCC, obligees are required to inform potential beneficiaries of the existence of a bond where the beneficiary would, objectively, suffer an unreasonable disadvantage by not being informed of the bond. Whether a beneficiary would suffer an unreasonable disadvantage is determined based on the circumstances in which the bond was entered into, including its terms, the nature of the industry and the beneficiary's entitlement under the bond.

In *Valard Construction*, the majority of the SCC held that the general contractor was required to inform Valard of the bond's existence because labour and material payment bonds are unusual in private oil sands projects, Valard was unaware of the existence of the bond, and its entitlement was time-limited, such that it was unable to claim on the bond due to the expiry of the notice period before it learned of the bond.

IMPLICATIONS

Owners and General Contractors (Obligees)

For obligees, *Valard Construction* creates a new administrative burden and legal risk. The test of whether a beneficiary would "suffer unreasonable disadvantage" due to lack of notice of the bond is unclear. Barring long-standing and well-known requirements for bonds on the type of construction at issue, it appears likely that notice of a bond will be required, or at least prudent.

The next question is "what is sufficient notice?". The SCC noted that the general contractor could have satisfied its duty by simply posting a notice of the bond at its on-site trailer where workers were required to attend site meetings on a regular basis. This would have ensured that a "significant portion" of the potential beneficiaries would have had notice of the bond.

This seems simple enough, but it is not hard to imagine scenarios where such posting does not in fact notify subcontractors and suppliers. For example, suppliers who simply drop off materials at the job site may never enter the trailer. Alternatively, there may be multiple job sites. If a notice is visible only to front-line employees of a subcontractor, is that sufficient to inform the subcontractor's management of the existence of the bond? Would an email suffice, or a clause in standard terms which all subcontractors are required to acknowledge? These and other questions will remain to be addressed over time as the extent of this new obligation is defined by parties and courts.

In the meantime, owners and contractors may wish to:

a. Review contractual documentation or contact subcontractors for current projects and identify any bonds naming them as obligees
b. Prepare notice procedures for current and future projects such that reasonable steps are taken to indicate the existence of a bond to as many potential bond beneficiaries as commercially practicable
c. Consider revising their contract documentation to include a requirement for all parties who obtain bonds either to identify potential bond beneficiaries or to notify potential bond beneficiaries of the existence of the bond on the obligee's behalf.

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