



SECTION 11.01 OF THE CCAA: EQUIPMENT LESSORS BEWARE

By Clayton Bangsund, Associate, Corporate Commercial Securities



INTRODUCTION

In the recent *Companies' Creditors Arrangement Act* (“CCAA”) proceedings of Cow Harbour Construction Ltd., the characterization of numerous leases, for the purposes of section 11.01 of the CCAA, was in dispute. The leading case on this issue is *Smith Brothers Contracting Ltd., Re*, a decision rendered by Justice Bauman of the British Columbia Supreme Court. Since 1998, *Smith Brothers* has frequently been cited as the leading decision respecting the interpretation of section 11.01 of the CCAA. However, the decision has also drawn considerable criticism from legal commentators, practitioners and equipment lessors, including numerous lessors involved in the Cow Harbour Construction Ltd. CCAA proceedings¹. This article examines the scope of section 11.01 of the CCAA.

ISSUE

Section 11.01 of the CCAA (section 11.3 at the time of the decision in *Smith Brothers*) is reproduced below:

No order made under section 11 or 11.02 has the effect of

- (a) prohibiting a person from requiring immediate payment for goods, service, use of leased or licensed property or other valuable consideration provided after the order is made; or
- (b) requiring the further advance of money or credit.

Section 11.01 appears to provide all lessors with the right to immediate payment for use of their leased property during a CCAA sanctioned stay of proceedings. In other words, the wording of the provision itself does not, on its face, limit the application of section 11.01 to any particular type of leasing arrangement. In *Smith Brothers*, however, Justice Bauman determined that there was indeed a limitation on the application of section 11.01 of the CCAA. To Justice Bauman, the operative words “payment for use” were of the utmost importance. In rendering his decision, Justice Bauman concluded that only payments for the use of leased property are excepted from a stay of proceedings issued under the CCAA. “Payment for use”, he posited, “evokes the notion of a true lease arrangement”. Thus, only the holder of a “true lease” (as discussed below in further detail) can reap the benefit of section 11.01 of the CCAA. Was Justice Bauman correct in limiting the application of section 11.01 of the CCAA to a particular type of true leasing arrangement?

¹ Steven J. Weisz, Linc A. Rogers & Stacy McLean, “Striking an Imbalance: The Treatment of Equipment Lessors Under Section 11.3 of the CCAA” (2003) 20:5 Nat. Insol. Review 45 [“Striking an Imbalance”]; Harvey G. Chaitin & John R. Hutchins, “Equipment Lessors in Restructurings: Hostage Lenders” (2009) 21:3 Comm. Insol. R. 21 [“Hostage Lenders”].



DECISION AND ANALYSIS

The Decision: Understanding the Scope of Section 11.01

In order to address the issue identified above, one must first understand the scope of section 11.01 as prescribed in *Smith Brothers*. Justice Bauman opted to “read down” the language in section 11.01. He stated that its benefit was only available to those lessors holding a “true lease”, and not to those lessors holding a “lease plus”. What, then, constitutes a “lease plus” that falls outside the scope of section 11.01?

According to Justice Bauman, section 11.01 “does not, at a minimum, include arrangements which are closer to financing agreements than true leases as discussed in the cases on the PPSA legislation”. Therefore, if a lease is considered a “security agreement” for PPSA purposes, it must be a “lease plus” that falls outside the scope of section 11.01.

He also clarified that leases not constituting “security agreements” for PPSA purposes may still fall outside the scope of section 11.01. In other words, the definition of “true lease” for the purposes of section 11.01 of the CCAA is narrower in scope than the definition of “true lease” for PPSA purposes.

At paragraph 61 of the decision, Justice Bauman provides further guidance respecting the characterization of leases:

It is only payments for the use of leased property that are excepted from a s. 11 stay order under s. 11.3(a). Payments for use *and* equity are not. Similarly payments for use *and* equity *and* an option to purchase are not. This is another reason to conclude the (*sic*) s. 11.3(a) is not inclusive of all forms of lease.

So, in order to characterize a lease for the purposes of section 11.01 of the CCAA, one should first conduct a PPSA analysis (including a review of the 16 factors discussed in the *Smith Brothers* decision). If the lease is a “security agreement in disguise” (referred to hereinafter as a “security lease”), then it is not afforded the protection under section 11.01. Even in the event that the lease is not a security lease, one must still consider whether the lessee is making “payments for use and equity” or “payments for use, equity and an option to purchase”. If the answer to either of these questions is in the affirmative, then the lease is a “lease plus” that falls outside the scope of section 11.01 of the CCAA. A lessor will only be entitled to the benefit of section 11.01 when the lease payments are solely for use of the property.

Analysis: Critiquing the Reading Down of Section 11.01

In ascertaining the appropriate scope of section 11.01 of the CCAA, Justice Bauman considered the intentions of Parliament and the object and scheme of the CCAA. Citing several Court decisions, he concluded that the CCAA is to be given a wide and liberal construction to further its policy objectives, which in the case before him, necessitated a “narrow construction of the types of arrangement that are excepted from a stay order”. On this basis, Justice Bauman opted to interpret section 11.01 narrowly. He clarified, however, that “any such construction (of section 11.01) must be



intellectually defensible on the basis of the words which Parliament has used in the section – I am not to redraft the section in the guise of construing it”.

At the outset of his analysis, Justice Bauman clarified that a conditional sales agreement could not reap the benefit of section 11.01 because “it is neither in form nor substance a lease of property”. It appears that one driving force behind his decision was that a lease, which in substance is a disguised security agreement (ie. a security lease), should receive no better treatment under section 11.01 than a conditional sales agreement (to which the provision does not apply). In other words, form should not trump substance under section 11.01 of the CCAA. Justice Bauman identified the anomalous result that would occur if a security lease was afforded the protection of section 11.01 while a conditional sales agreement (which is the substantive equivalent of a security lease) was not. It appears that much of the impetus behind Justice Bauman’s decision was to cure this mischief and reconcile the anomalous result.

If Justice Bauman wished to read down section 11.01 of the CCAA such that a security lease would be treated in the same manner as a conditional sales agreement, it is curious that he did not enunciate a principle to that very effect (i.e. that a PPSA lease analysis is identical to a lease analysis for the purposes of section 11.01 of the CCAA). Instead, Justice Bauman articulated principles dictating that the proper analysis under section 11.01 is even more stringent than its PPSA counterpart. Why did he enunciate the “true lease” test in this manner? To further the policy objectives of the CCAA? Undoubtedly this was at least part of the reason, but while Justice Bauman’s scheme may have furthered certain policy objectives, it arguably imposes an unjust result on lessors excluded from its application. In addition, one can argue that Justice Bauman’s “reading down” of the provision is in direct contravention of section 11.01(b) of the CCAA, which does not allow an order to require the further advance of credit. For example, if one accepts that a security lease is really a credit sale arrangement in disguise, then isn’t a lessor under such a lease being required to advance additional credit during the stay?²

As the saying goes, “it’s easier being a critic”. And although there are many critics of Justice Bauman’s decision, one must acknowledge the delicate balance he was trying to strike in articulating the appropriate interpretation of section 11.01, and commend him on his effort in doing so. Indeed, his approach to the *Cow Harbour* decision in August 2010 has found favour with the Court.³

CONCLUSION

It may be that regardless of the manner in which section 11.01 is interpreted and applied, points of contention and unfairness will arise. If, for example, the Court were to resort to a literal interpretation of section 11.01, anomalous results would arise as between security leases and conditional sales agreements. Furthermore, the Court’s ability to implement the overall objective and scheme of the

² The counter to this argument is that a lessor grants credit up front, and simply awaits full payment of the indebtedness on a term basis. In any event, an unpaid lessor with an interest in the leased equipment only, is both deprived of immediate payment as well as the benefit of the productivity of the business as a going concern. This is to be distinguished from a lead creditor holding a security interest in all present and after-acquired property.

³ In the recent *Companies’ Creditors Arrangement Act* proceedings of Cow Harbour Construction Ltd. (Action No. 1003 05560, Bankruptcy Action No. 24-115359), Yamauchi J. of the Court of Queen’s Bench of Alberta wholly adopted Justice Bauman’s interpretation of section 11.01 of the CCAA, as enunciated in *Smith Brothers*.



CCAA would arguably be weakened. On the other hand, if the Courts' current interpretation and application of section 11.01 prevails, lessors falling outside the scope of section 11.01 will continue to be held hostage by CCAA proceedings, being forced to wait unpaid while their equipment depreciates for the sole benefit of the CCAA applicant and its general creditors.

One thing is clear; Until the decision in *Smith Brothers* is explicitly overruled, those leases providing anything more than "payment for use" will not enjoy the protection of s. 11.01 of the CCAA. Those in the business of leasing equipment should take note if they wish to avoid being inadvertently ensnared in CCAA proceedings.