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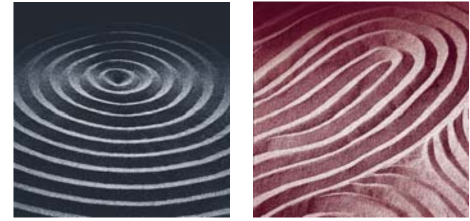

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The *Bulk Sales Act* and the decision of the Supreme Court of Canada in *National Trust Co. v. H&R Block Canada Inc*

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Jeffrey C. Carhart

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• THE *BULK SALES ACT* AND THE DECISION OF THE SUPREME COURT OF CANADA IN *NATIONAL TRUST CO. v. H&R BLOCK CANADA INC.* •

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Miller Thomson LLP, Toronto

The Supreme Court of Canada cast new light on the Ontario *Bulk Sales Act*[1] (the "Act") with its 2003 decision in the case of *National Trust Co. v. H&R Block Canada Inc.*[2] In 1999, I wrote an article[3] with respect to another major judicial decision concerning the Act — namely, Mr. Justice Blair's decision in the *Canadian Red Cross Society* proceedings under the *Companies' Creditors Arrangement Act*, as affirmed by the Ontario Court of Appeal. In that article, I set out the basic parameters of the application of the Act. The Act applies to a sale of "stock in bulk" (with the companion phrase "sale in bulk" being defined to mean "a sale ... out of the usual course of business or trade of the seller"[4]).

Although the definition of "stock" focuses on tangible assets alone,[5] the broader term "stock in bulk" unmistakably encompasses real estate[6] because it is defined as follows:[7]

> "stock in bulk" means stock or part thereof that is the subject of a sale in bulk *and all other property, real or personal, that together with stock is the subject of a sale in bulk.* [Emphasis added.]

Therefore, in plain and simple language, the Act could apply to the sale of real property. What would be required is that the real property be part of a bundle of assets which constitute "stock" being sold out of the usual course of the seller's business.

Compliance with the Act can be achieved by the seller providing an affidavit listing all of the seller's "trade creditors" classified as either secured or unsecured. The definitions of secured and unsecured trade creditors focus on people who have supplied "stock, money or services...for the purpose of enabling the seller to carry on a business".[8] In his decision in the *Canadian Red Cross Society*, Blair J. noted that the definitions do *not* speak of creditors with purely contingent claims, such as the type of damages

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claims which victims of the tainted blood scandal had against the Red Cross Society.[9]

If the amounts shown on the affidavit exceed $2,500, the purchaser comes under an onus to obtain verification that the creditors are being provided for as part of the terms of the sale. Within five days of completion of the sale, the purchaser must file an affidavit, in prescribed form and content, with respect to the sale in the relevant court office.

Other (less common) ways of complying with the Act including, having the sale approved by the court, or where a trustee is appointed by the relevant creditors to receive the purchase funds and to distribute them among the creditors.

EXEMPTIONS FROM THE ACT

There are two major grounds pursuant to which a transaction can be exempt from the application of the Act.

The first major category is found in s. 2 of the Act[10] which exempts sales of assets of companies that have formally lapsed into bankruptcy or that have come under the legitimate exercise of the rights of a secured creditor or other properly authorized officials. In those cases, the vendor is not the company itself. Section 2 of the Act provides, in full, as follows:

> **2.** This Act applies to every sale in bulk except a sale in bulk by an executor, an administrator, a guardian of property under the *Substitute Decisions Act, 1992*, a creditor realizing upon security, a receiver, an assignee or trustee for the benefit of creditors, a trustee under the *Bankruptcy Act* (Canada), a liquidator or official receiver, or a public official acting under judicial process. R.S.O. 1990, c. B.14, s. 2; 1992, c. 32, s. 2.

The second major category of exempt transactions are ones which have been ordered to be exempt by the court. In that regard, s. 3(1) of the Act provides specific jurisdiction for the seeking of such orders, on the following terms:

> **3.** (1) A seller may apply to a judge for an order exempting a sale in bulk from the application of this Act, and the judge, if satisfied, on the affidavit of the seller and any other evidence, that the sale is advantageous to the seller and will not impair the seller's ability to pay creditors in full, may make the order, and thereafter this Act, except section 7, does not apply to the sale.

Classically, of course, this section was used by very large companies who were demonstrably quite solvent and who could provide evidence to the court that the relatively cumbersome procedure involved in preparing a full Act exemption was effectively not necessary in order to protect the vendor's creditors. As I said in my 1999 *Commercial Insolvency Reporter* article, a classic example of such a situation would be if a large multi-national company like Daimler-Chrysler Corporation wanted to sell the assets of a small production facility for $2,000,000. Technically, the Act would require Daimler-Chrysler Corporation to provide affidavit evidence with respect to *all* of its trade debt. In order to relieve itself of that kind of administrative burden, vendors in cases like that typically apply to the court for orders allowing them to complete the sales without compliance with the Act.

As I went on to discuss in my 1999 *Commercial Insolvency Reporter* article, Blair J. held in the *Red Cross* case that insolvent corporations may also seek exemption orders under s. 3 of the Act. In short, he held that if the proper evidence can be submitted to the court to establish that the sale is the most advantageous one in the circumstances — and at least in that sense it does not "impair" the vendor's ability to pay creditors in full (*i.e.*, although the ability is less than perfect, it is not rendered even worse as a result of the sale) — exemption orders will still be granted to such corporations.

THE EFFECT OF NON-COMPLIANCE WITH THE *BULK SALES ACT*

Section 16 of the Act deals with the effect of non-compliance.

Section 16 provides in full as follows:

> **16.** (1) A sale in bulk is voidable unless the buyer has complied with this Act.
>
> (2) If a sale in bulk has been set aside or declared void and the buyer has received or taken possession of the stock in bulk, the buyer is personally liable to account to the creditors of the seller for the value thereof, including all money, security and property realized or taken by the buyer from, out of, or on account of, the sale or other disposition by the buyer of the stock in bulk. R.S.O. 1990, c. B.14, s. 16.

NATIONAL TRUST CO. v. H&R BLOCK CANADA INC.

Section 16 of the Act came under consideration by the Supreme Court of Canada in 2003 in the case of *National Trust Co. v. H&R Block Canada Inc.* The essential facts of that case were as follows:

- National Trust Co. ("National Trust") provided financing to a company called Tax Time Services Ltd. ("Tax Time") which was in the business of preparing tax returns and providing discounting of tax refunds, from 1984 through 1987. The relationship broke down over a contractual dispute in 1987 and litigation between National Trust and Tax Time began.

- In 1991, when the litigation between National Trust and Tax Time "was [still] ongoing".[11] H&R Block Canada Inc. ("H&R Block") bought a bundle of assets from Tax Time. The purchased assets included assets used in Tax Time's business as well as a customer list and associated goodwill. H&R Block also received the benefit of a non-competition clause.

- The purchase price was $800,000.

- At the time of the sale by Tax Time to H&R Block, all of Tax Time's assets had been pledged to a group of institutional lenders, including First City Trust Company (who was in first position) and the Royal Bank of Canada (who was in second position). In all, there were seven secured lenders and Tax Time "...also had 35 unsecured creditors, one of which was National Trust".[12]

- H&R Block paid $800,000 to Tax Time for the purchased assets. There was absolutely no compliance of any nature with the Act. Among other things, H&R Block "did not demand or receive a list of creditors from Tax Time; it gave no notice to the creditors of Tax Time; nor did it seek consent from such creditors".[13] The agreement did contain a provision to the effect that Tax Time would indemnify H&R Block from the effect of non-compliance with the Act.

- Tax Time paid $425,000 of the proceeds to First City Trust Company which "apparently"[14] was

> sufficient to discharge all indebtedness to First City Trust Company and the balance was paid to the Royal Bank — "[h]owever, the Royal Bank was not paid in full"[15] from such funds.

Mr. Justice Spence of (what was then) the Ontario Court of Justice General Division granted National Trust's application to require H&R Block to account to the court for the amount which it claimed that it was owed by Tax Time.[16] Mr. Justice Spence ordered H&R Block to pay "again" or to "pay twice" in the sense that they were ordered to pay to H&R Block the "same $800,000" that they had already paid to Tax Time in contravention of the Act. Mr. Justice Spence's decision was upheld by the Ontario Court of Appeal.[17]

It would be an understatement to say that H&R Block received a favourable decision from the Supreme Court of Canada. Notwithstanding a strong dissent — and which dissent was entirely correct as far as I am concerned — in a judgment delivered by Mr. Justice Bastarache, the Supreme Court held that while the sale was void under s. 16(1), National Trust was not, in fact, entitled to any damages under s. 16(2) of the Act.

In departing from the two Ontario judgments, Bastarache J. takes what he describes as a "purposive" approach to s. 16 of the Act. In the end — and I will return to a more detailed consideration of what Bastarache J. says in a moment — this approach to the Act leads him to the "dream" result that H&R Block wanted: namely, that their violation of the Act had no consequences. In plain terms, Bastarache J. says that — viewed from a perspective of "...facilitat[ing] transactions and economic efficiency"[18] — he is satisfied with the use of the proceeds in the Tax Time sale and therefore sees no need to require H&R Block to be penalized in any way, for what can only be described as a flagrant violation of the Act.

In a strong dissent, Madam Justice Deschamps argues for giving effect to the punitive effect of s. 16 of the Act in this particular case.[19] As she states at the outset of her decision, "[w]here the law is clear, not even the most dynamic interpretation can justify going beyond the rules set out regarding the consequences of its violation".[20]

Madam Justice Deschamps carefully sets out the history of the Act which "...states a bright-line rule"[21] in s. 16. As she goes on to state, in part:[22]

> The purpose of the Act is to hold the [non-complying] buyer liable for an amount equal to the value of the property. An interpretation based on the use of the proceeds of sale to pay the secured creditors would undermine the spirit of the Act, which is intended to protect not only secured creditors but also ordinary creditors.
>
> ...
>
> The consequences of violating the Act must...be different from the consequence of complying with the Act.

In closing, Deschamps J. notes that the approach taken by Bastarache J. and the majority of the Court who chose to follow him:[23]

> ...is not...consistent with either the general objective of the Act or its specific objectives. Participation by all classes of creditors, and more specifically by the ordinary creditor class, is circumvented, judicial review is evaded, and the parties have no incentive to comply with the Act....
>
> ...
>
> [It is] an interpretation [of the Act] that allows...debtors to sell their assets on the sly.

Madam Justice Deschamps notes that violation of the Act is supposed to have "financial consequences"[24] which by reading the Act "the parties [could have] anticipated".[25] In direct repudiation of Bastarache J.'s approach to relieve H&R Block of the effect of the penalty clause in the Act which Deschamps J. thought — as so many of us did — was "automatic".[26] Madam Justice Deschamps states:[27]

> It is not the function of judges to substitute their judgment for the wills of the legislature or the parties to minimize the impact of commercial legislation that they believe to be cumbersome or unfair.

Certainly, on a fundamental level, it seems as if H&R Block really got away with something as a result of Bastarache J.'s decision. In plain terms, H&R Block chose not to comply with the Act and yet, after years of expensive litigation, they were told that they had, in fact, escaped punishment because — again in plain terms — Bastarache J. ruled that it was simpler to have just done what they did (namely, to have Tax Time distribute the $800,000 to the two apparently[28] highest ranking secured creditors) than to have gone through the relatively cumbersome steps[29] necessary actually to grapple with the Act (*i.e.*, presumably, by

seeking an exemption order, given that compliance was not possible).[30]

It just seems wrong for someone to escape punishment for by-passing clear-cut legal requirements on the basis "the end result" was nevertheless "economically efficient". As Jeffrey Lem wrote, in part, in his annotation of *National Trust Co. v. H&R Block Canada Inc.* in the *Real Property Reports*:[31]

> While it is difficult for any practising solicitor to say much about a "motherhood" statement like the Supreme Court's policy imperative to "facilitate economically-efficient transactions", it is nonetheless one of those judicial directives that this annotator finds actually quite difficult to apply. There is nothing in the reasoning that necessarily demands that the *ratio* in *National Trust* be strictly constrained to the Act itself or to the facts in *National Trust*. Using a purely real property example, consider the differences between a quit claim deed given by a mortgagor to its mortgagee, and the longer and more expensive judicial foreclosure proceedings that such mortgagee could bring against the mortgagor in order to vest itself with title to the mortgaged property. There is no doubt that the "deed-in-lieu" remedy is certainly the far more economically-efficient transaction, but it also has the unfortunate disadvantage of leaving all subordinate encumbrances in tact and binding upon successors in title (including the mortgagee taking under such deed-in-lieu). In contrast, a final order of foreclosure or a sale under power of sale typically cuts out all such subordinate encumbrances. Should or could *National Trust* be applied to bar subordinate encumbrancers under such circumstances from their respective claims when a mortgagor itself sells the mortgaged property (either to the mortgagee or to a third party with proceeds directed to the mortgagee), instead of allowing the mortgaged property to be foreclosed or sold under power of sale by the mortgagee in the ordinary course? After all, the subordinate encumbrancers would clearly have had no legal recovery whatsoever had the mortgagee bothered to formally foreclose or sell under power of sale (there is a presumption that, as in *National Trust*, the proceeds are insufficient to retire the mortgagee's secured debt). Should the mortgagee be required to endure the material delay and increases in legal and other transaction costs that would be required for a formal remedy, when the subordinate encumbrancers have no realistic hope of realizing any recovery? Indeed, an extrapolation of *National Trust* might suggest that, so long as it can be shown that realization against the assets cannot fully retire the highest ranking secured debt, then other creditors really should not have any "rights" at all, since compliance with such rights could only lead to economic inefficiencies. Is this "so long as it would not have made a difference" philosophy really the logical application of the *National Trust* decision? If so, the scope of legislation that may now be affected by this efficiency doctrine is considerable.

I have always felt that the Act occupies a very important place in the web of laws which, in general terms, regulate the field of insolvency. One can, in turn, view those laws from multiple perspectives; two fundamental perspectives that readily come to mind are:

- What tools are available to a creditor to attack a transaction by an insolvent party which he feels was designed to try to remove assets improperly from his avenues of recovery?
- What steps should someone who is insolvent follow to ensure that what might seem, on an instinctive level, to be a "legitimate" transaction will, in fact, stand up to later scrutiny or attack?

The Act forms part of the essential answer to each of those questions; in turn, obviously, the overall goal of this field of legislation is to promote fair dealing with a sensible level of certainty.

If a company has assets that are worth between \$1.0 million and \$1.2 million and it also has debts of \$4.0 million then, I have always felt, the Act should be there to act as an impediment to an unregulated sale of those assets, out of the ordinary course, for, say \$1.1 million — *i.e.*, even though, of course, one could readily argue, the sale is within the range of "fair market value".

In that example, on a balance sheet test, the vendor is quite insolvent — just as Tax Time was in the *National Trust* case. What the Act is supposed to do, as I see it, is to cause the vendor and the purchaser in that proposed transaction to realize that they need to structure the transaction differently than an ordinary sale. There are different alternatives available. Perhaps a receiver should be appointed by the court to scrutinize the sale and then, perhaps either complete the sale privately or recommend it to the court for approval. Perhaps, the vendor should file for "protection" under either the *Bankruptcy and Insolvency Act* or the *Companies' Creditors Arrangement Act*; in turn, within the scope of proceedings under those statutes, perhaps an

order could be sought granting an exemption from application of the Act. Note that in those scenarios, there is a respectable "due process" whereby the creditors — including those creditors who are seemingly "out of the money" — can step forward (if they chose to do so) to speak to either a receiver or the court as to whether or not the sale should be allowed to proceed. The point is that the Act is meant to prevent insolvent companies from liquidating their assets "on their own" or, as Deschamps J. put it, "on the sly".

So — did Bastarache J.'s decision in the *National Trust* case relegate the *Bulk Sales Act* to the scrap heap of statutes? In the final analysis, the answer is "no" on at least two levels.

First, in practice, from what I can see (in Toronto at least) no one is treating the decision as a *carte blanche* to simply ignore the Act. Numerous restructuring court cases have proceeded since the *National Trust* decision and on a regular basis, *Bulk Sales Act* exemption orders are routinely sought when assets are sold in bulk out of the ordinary course. No one is acting as if the Act is no longer a concern.

Second, the fact is that Bastarache J.'s decision was very much limited to the facts of the *National Trust* case and any one who is considering buying the assets of an insolvent company would be very ill-advised to simply put a clause in the agreement which effectively says "do the right thing with the money"[32] and proceed to close the transaction without any further consideration of the Act. Although Bastarache J.'s decision in the *National Trust* case *might* be of assistance to such a purchaser, equally it might not, because, again, Bastarache J.'s decision was confined to a significant extent to the facts of that particular case.

Some of the key passages in Bastarache J.'s decision should be carefully read in that context. For example, Bastarache J. holds that what s. 16(2) of the *Bulk Sales Act* means is that, where a bulk sale has been set aside or declared void,[33]

> ...the buyer must account for what is owed, taking into consideration *what was properly paid* out to creditors from the sale in bulk.... [Emphasis added.]

That is, there will be cases where the buyer will not be able to satisfy a court that what is done with the money is "proper" (and the absence of compliance with the Act will, therefore, presumably have consequences).

Mr. Justice Bastarache goes on to state:[34]

> In my opinion, a modern accounting should take into account proper payments to priority-ranking creditors made as a direct result of payment to the seller of the bulk goods and should not result in an unjust enrichment to creditors who would not otherwise have recovered money from a compliant sale. Accounting for the use of proceeds does not equate to repayment of these proceeds by the buyer *in every case*. [Emphasis added.]

The reference to "in every case" alone clearly limits this decision to the particular facts of that case.

Of course, the issue of what constitutes "prior ranking debt" is one which requires constant re-evaluation of the changing statutory provisions and the relevant case law.

To provide an example, over the last 20 years there have been enormous changes on the way in which (the various "levels" of) government claims against an insolvency company — sometimes depending on whether the debtor company is bankrupt or not — have been recognized by the statutes and the courts. What constituted the "state of the art" in that regard in 1985 is quite different from what it was in 1995 and what is now in 2005. (One can reasonably expect future important developments in that area.) I suggest that it is inappropriate to simply leave the matter of adjudicating who is entitled to the proceeds "first" to the vendor and the purchaser where a vendor is insolvent. The process should properly be regulated, as it invariably is, by either a court-based process or a qualified receiver/trustee.

In turn, there are numerous other potential "pitfalls" for a purchaser and an insolvent vendor in seeking to determine who "comes first" in terms of entitlement to a pool of proceeds which is, by definition, going to be insufficient to pay all of the vendor's creditors. Again, just to scratch the surface of that complex subject, suppose that the party who "appears" to have a first-ranking security interest holds security which is, in fact, subject to legitimate challenge. There is no end to the difficulties which could potentially be associated with security — and the matter is far more complex than simply glancing at a *Personal Property Security Act* printout to see who looks like they have the "oldest" registration. In the fact situation in *Tax Time*, I was intrigued by the fact that *National Trust* litigation began in 1987 and then when the sale occurred in 1991, the funds were used to pay a couple of secured creditors. I was curious as to when that supposedly first-ranking security was put in

place? If the security was purportedly "granted" by Tax Time after the *National Trust* litigation had started, query whether, in fact, it was completely without controversy? Again, if the Act is ignored and there are no consequences to such a cavalier approach to the Act, then the adjudication of those kinds of issues could simply be left solely to the vendor and the purchaser which is just not right.

One could go on to list many other areas of controversy which might be associated with a sale of assets by an insolvent company, out of the ordinary course. For example, there is always the question of whether the sale was conducted in a commercially reasonable way and whether the price obtained therefore truly reflects fair market value (as opposed to a "sweetheart deal" which is carried out quickly at below market value for whatever improper reason)? In fairness to Bastarache J., I do note that he commented in his decision that "...the sale price of $800,000 [in the *H&R Block* case] is not contested".[35]

Further, Bastarache J. writes:[36]

> ...One of the conditions of the sale...[in this case] was that the proceeds of the sale be used to pay [the seller's] creditors in order of priority in order to secure a free title.
>
> ...
>
> While the inclusion of this condition of sale is quite compelling in the present case, *it should not be seen as a requirement in the decision-making process of determining whether or not to relieve the non-compliant buyer of a strict liability* to account to the seller's creditors. Instead, it constitutes a factor to consider in the general context of the sale. [Emphasis added.]

Mr. Justice Bastarache is clearly saying that just by putting in a clause that effectively says "do the right thing with the money" will not be good enough in any particular case.

CONCLUSION

In my view, insolvent companies should lose the right to simply dispose of their own assets in bulk, out of the ordinary course, without any court or other proper supervision and vendors who chose to partake in such an exercise should always be punished, as Deschamps J. and the Ontario Court of Appeal agreed.

As I hope I have demonstrated in this article, although Bastarache J. clearly parts company with myself, Deschamps J. and the Ontario Court of Appeal, when it comes to my proposition his departure is of a very limited nature and really amounts to a disagreement over the word "always". I think even Bastarache J. would agree that it is quite possible that on any given factual situation such punishment should, in fact, be meted out and might, in fact, be of a severe nature. As a result, although Bastarache J. dealt it a blow, the *Bulk Sales Act* is still standing and still, in my view, performs an important service in the field of insolvency law.

[*Editor's note*: Jeffrey C. Carhart is a partner at the law firm Miller Thomson LLP, his areas of practice are corporate insolvency and corporate finance.]

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1 R.S.O. 1990, c. B.14, as amended. References to section numbers are to sections of the *Bulk Sales Act* unless otherwise indicated.

2 [2003] S.C.J. No. 70 (QL), 14 R.P.R. (4th) 1 ("*National Trust*").

3 "Bulk Sales by Insolvent Vendors — Some Recent Jurisprudence From the Canadian Red Cross Society CCAA Proceeding" (1999) 11 Comm. Insol. Rep. 57.

4 Section 1.

5 Section 1: "stock" means,
(a) goods, wares, merchandise or chattels ordinarily the subject of trade and commerce,
(b) the goods, wares, merchandise or chattels in which a person trades or that the person produces or that are the output of a business, or
(c) the fixtures, goods and chattels with which a person carries on a trade or business.

6 As well as other assets, such as intangible personal property.

7 Section 1.

8 Section 1.

9 *Re Canadian Red Cross Society*, [1998] O.J. No. 3306 (QL), 5 C.B.R. (4th) 299 at 317 (Gen. Div.).

10 As I discussed in my 1999 article in the *Commercial Insolvency Reporter*.

11 *National Trust*, at 10.

12 *Ibid.*

13 *Ibid.*

14 *Ibid.*

15 *Ibid.*

16 The trial judgment is unreported. The Ontario Court reference is Doc. B343/95 (Ont. Ct. (Gen. Div.)).

17 The Court of Appeal decision is reported at, [2001] O.J. No. 4127 (QL), 46 R.P.R. (3d) 182.

18 *National Trust*, at 16.

19 Indeed, with H&R Block's win at the Supreme Court of Canada level, it was National Trust — not H&R Block — who was punished for H&R Block's viola-

tions of the Act because National Trust was saddled with a cost award for the entire litigation.

20 *National Trust*, at 21.

21 *Ibid.*, at 24.

22 *Ibid.*, at 25.

23 *Ibid.*, at 26.

24 *Ibid.*

25 *Ibid.*

26 *Ibid.*

27 *Ibid.*

28 See my discussion ahead as to how difficult it can be to determine which creditor "really" ranks highest.

29 As discussed ahead, not only do I think those steps are not really cumbersome but I also think they are essential to the integrated set of insolvency laws which are so important in this country.

30 It may be noted that the insertion of the "indemnity for non-compliance" clause in the Tax Time agreement of purchase and sale seems hard to understand. Certainly, it seems to have been the case that H&R Block and Tax Time knew that: (i) Tax Time had far more debt than the proceeds of the sale; (ii) Tax Time was, by definition, divesting itself of *all* of its assets; and (iii) therefore, Tax Time would have absolutely no assets to use, and therefore no ability whatsoever, to satisfy its obligations under its agreement to indemnify H&R Block for the failure to comply with the Act.

31 *National Trust*, at 6.

32 And perhaps include a demonstrably worthless "indemnity" with respect to the contravention of the Act.

33 *National Trust*, at 17.

34 *Ibid.*, at 18.

35 *Ibid.*, at 10.

36 *Ibid.*, at 19.

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