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If a debt is outstanding, but not enforceable in court… is it really a debt?

June 17, 2021

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The classic pseudo-philosophical question of: *If a tree falls in a forest when no one is around to hear it, does it make a sound?* reveals a tension around the importance of human experience on the meaning of words. Is "sound" something that is dependent on it being experienced – a person *hears* "sound"? Or is "sound" something that is physically independent, describing the physical vibrations that are produced from the force of a tree falling? Based on a recent decision of the Ontario Superior Court of Justice, it appears that the answer to this question would be that unless someone was around to hear it, the tree would make no sound.

In the case of *In re John Trevor Eyton*, 2021 ONSC 3646 ("***Eyton II***"), Justice Dunphy upheld the decision of Master Mills (as she then was) sitting as a Registrar in Bankruptcy that departed from a fairly common view in the insolvency world in Ontario that a statute-barred claim could still be a "provable claim" in bankruptcy. Prior to this recent decision, it was generally believed that even if a creditor were barred from commencing a legal proceeding due to the expiration of a limitation period under the *Limitations Act, 2002*[1] (the "***Limitations Act***"), the debt was not thereby extinguished, and as such, the creditor could participate in bankruptcy proceedings, or other similar insolvency proceedings, as the debt was still a "provable claim".

The Superior Court in *Eyton II* has clearly said this is no longer the case. Going forward, creditors, debtors, and trustees (or similar court-appointed officers) will need to be mindful of limitation periods and all the baggage that this might entail, including discoverability, debt acknowledgment, and part payments. While the Court may have sought an equitable result, the unintended effect may have been to introduce further evidentiary issues into what is intended to be a summary process.

Background

The underlying facts are not overly important. It is sufficient to know that the underlying debt of the creditor in this case was evidenced by a promissory note that had long come due, and the last payment received in respect of the debt was made in 2016.

It appears from the decision that the debtor had attempted to make a Division I Proposal, which was ultimately unsuccessful, and as such, was deemed to have made an assignment in bankruptcy on April 3, 2019. The debt owing to the creditor was listed by the debtor in the Statement of Affairs in the Proposal proceeding. The creditor filed a proof of claim on July 27, 2020.

The Trustee disallowed the claim on the basis that it was statute-barred under the *Limitations Act*. The creditor appealed the disallowance to the Registrar in Bankruptcy. Master Mills rejected the appeal ("***Eyton I***"[2]) and the creditor appealed her decision to a judge of the Superior Court.

Temple

Before turning to the decisions of Master Mills and Justice Dunphy, it is worth pausing to briefly summarize the *Temple* decision. [3] In this 2012 decision, Newbould J. undertook a careful analysis of the impact of the *Limitations Act* on bankruptcy proceedings. In this case, a creditor with a claim that was statute-barred brought an application for a bankruptcy order (the modern version of "petitioning a debtor into bankruptcy"). In deciding whether such a creditor could bring an application for a bankruptcy order, Newbould J. determined that a bankruptcy application was not a proceeding in respect of a "claim" within the meaning of the *Limitations Act*, which defined "claim" as "a claim to remedy and injury, loss or damage that occurred as a result of an act or omission".[4] This is consistent with the jurisprudence that holds that a bankruptcy application is not a particular creditor's remedy, but is intended to bring about the orderly and fair distribution of the property of the bankrupt among its creditors on a *pari passu* basis.

Justice Newbould determined that a debt that is statute-barred pursuant to the *Limitations Act*, continues to be a debt that is owing and can be a provable claim. In reaching this conclusion, Newbould J. noted that the Ontario *Limitations Act* is procedural and does not affect substantive rights, and expressly only affects substantive rights when applying conflict of laws rules.[5] In other words, it prevents the commencement of proceedings to enforce a debt but does not extinguish the debt. Newbould J. noted that this was distinct from civil law jurisdictions and certain provinces such as British Columbia that have expressly provided for the extinguishing of substantive rights.[6]

As a result, in *Temple*, the creditor with a statute-barred claim was permitted to seek a bankruptcy order against the debtor.[7]

Implicit in *Temple* is that if a creditor with a statute-barred claim can commence a bankruptcy application, then a statute-barred claim is a "provable claim" within the meaning of the *Bankruptcy and Insolvency Act*[8] (" ***BIA***"). Section 43(1) of the *BIA* provides that "one or more creditors" may file an application for a bankruptcy order. Section 2 of the *BIA* defines "creditor" as "a person having a *claim provable* as a claim under this Act [Emphasis added]." By granting such a creditor standing under s. 43, *Temple* also stands for the proposition that a statute-barred claim is a "provable claim", and would not, by that fact alone, be disallowed as a provable claim.

Decision of Master Mills

Master Mills relied on a "long history of case law" that included decisions from 1922[9], 1943[10], 1988[11] (" *Farm Credit*") and 1996[12] (" *Central Capital*") for the principle that a provable claim in bankruptcy must be "recoverable by legal process".[13] In doing so, she distinguished or declined to follow *Temple*. She considered Justice Newbould's comments that a statute-barred claim may nonetheless be a provable claim in bankruptcy to be *obiter*.

The thrust of Master Mills' reasoning is found in paragraph 11 where she expresses her concern that:

Creditors must not be permitted to use the provisions of the BIA to effectively revive their enforcement rights and collect on statute barred debts. This is not the intention of the BIA which provides for the fair and orderly distribution of the bankrupt's property among the creditors with proven and enforceable claims.

However, one should note that often, creditors are not *using* the provisions of the *BIA* to revive debts. In many cases, it is the debtor that voluntarily makes an assignment into bankruptcy or is deemed to have made an assignment after a failed proposal (voluntary), as in *Eyton*. Also, s. 141 of the *BIA*, which sets out the general distribution scheme, simply provides, "Subject to this Act, all claims proved in a bankruptcy shall be paid rateably." There is no requirement that a claim be "proven and enforceable" as Master Mills states.

Decision of Dunphy J.

Justice Dunphy, in considering the creditor's argument that a statute-barred claim could still be a provable claim in bankruptcy, finds that it would lead to an "absurd result."[14] In support, Dunphy J. notes (correctly) that the underlying policy of the *BIA* is to provide for the equitable distribution of assets among creditors of the same rank.[15] However, Dunphy J. finds that a statute-barred claim is not of the same rank as other unsecured claims because that creditor could not enforce payment.[16] To Dunphy J. (similar to Master Mills), permitting a statute-barred claim to be a provable claim in bankruptcy would allow an unenforceable claim to become enforceable simply because a bankruptcy occurs.

Dunphy J. goes on to provide an analysis based on a "careful reading" of the *BIA*:

1. Section 121 of the *BIA* limits provable claims to debts and liabilities "to which the bankrupt is *subject*" [emphasis added by Dunphy J.], and where "subject" means the claim must be enforceable;
2. Even though the *BIA* is federal, provincial laws establish property and civil rights;
3. The term "proceeding" as used in the *Limitations Act* is intentionally broad encompassing remedies of all kinds; and
4. Section 124 of the *BIA* requires every creditor to prove its claim in order to share in the estate, and that filing a proof of claim is a "proceeding", "applying the broad and purposive reading afforded this term in, for example applying the stay of proceedings language of s. 69(1)(a) of the *BIA*".[17]

While acknowledging that debts are not extinguished by the *Limitations Act,* Dunphy J. refers to these types of unenforceable claims as subsisting in the "Twilight Zone", along with illegal gambling debts and debts arising from the sale of illegal narcotics.[18]

Dunphy J. concurs with Master Mills that Newbould J.'s comments in *Temple* on this issue were *obiter* and relies on *Central Capital* as being more applicable to the case at bar, including the reliance in *Central Capital* on the *Farm Credit* decision from Alberta. Ultimately, Dunphy J. finds that the creditor's claim, being one that was not enforceable by reason of s. 4 of the *Limitations Act*, is not provable within the meaning of s. 121(1) of the *BIA,* and therefore not a claim to which the bankrupt is subject.

Commentary

Before turning to the potential impact of this decision, there are a few concerns with the reasons of both Master Mills and Dunphy J. that are worth noting.

Unenforceable at law

In both decisions, the court relied on the *Central Capital* decision of the Ontario Court of Appeal, and the *Farm Credit* decision referenced by the Court of Appeal. In *Central Capital,* the claim (which was based on a right to require a company to redeem shares) was unenforceable not because of a limitation period, but because a provision of the *Canada Business Corporations Act* prohibits a corporation from redeeming shares if insolvent.[19] In *Farm Credit*, the claim (which was based on monies still owing on a mortgage debt after the lender had foreclosed on the mortgaged property) was unenforceable because the *Law of Property Act* in Alberta extinguished the right of action on the covenant if an action had been brought on the mortgaged land.[20]

Arguably, these are fundamentally different issues than a debt that is statute-barred. In the case of *Central Capital,* the corporation was statutorily prohibited from redeeming shares in the event of insolvency. The corporation did not have the legal power to redeem, and the creditor's right to require redemption would have always been subject to the powers of the corporation set out in the statue.In other words, the right of the creditor to require redemption was not enforceable *at law*. In *Farm Credit,* the language of the statute effectively extinguished the right of action of the lender: "…no action lies… on a covenant for payment contained in the mortgage…" Again, the statute eliminated the right of action *at law*.

Dunphy J. reinforces this concept of "unenforceability" by giving the examples of the "illegal gambling debt" or the "debt arising out of illegal narcotics". However, these too are examples of claims that are unenforceable at law as they are examples of illegal contracts.

However, in the case of a claim that is statute-barred, the legal rights are not extinguished (as acknowledged by Master Mills and Dunphy J.). Only the right to commence a legal proceeding is barred. A debt may still be enforceable by other means without commencing a court action (e.g., set-off, enforcement of security, or demand letters). Another consideration is that if a claim is statute-barred, then this can be raised as a defence to a claim. If the defence is not raised, an action could continue, and judgment obtained.

In other words, whereas the rights in *Central Capital* and *Farm Credit* were *legally* unenforceable, in the case of a debt that is statute-barred, the claim is only *procedurally* unenforceable. This is the distinction that is made by Newbould J. when discussing the fact that in Ontario, a limitation period is a matter of procedural law, not of substantive law. Only where there is a conflict of laws issue is the limitation period in Ontario a matter of substantive law. By interpreting a statute-barred debt as "unenforceable at law" and, therefore not a provable claim, is to effectively elevate the limitation period to a matter of substantive law.

Proof of Claim and Rankings

Dunphy J. appears to have also taken an overly (and unwarranted) broad view of the meaning of "proceedings". Section 2(1) of the *Limitations Act* expressly provides that the act only applies to court proceedings, except those proceedings that relate to certain statutes or rights. Yet, Dunphy J. in discussing s. 4 of the *Limitations Act* comments that the term "proceeding" is intentionally broad. Later, Dunphy J. holds that the act of filing a proof of claim in a bankruptcy is a "proceeding", "applying the broad and purposive reading afforded this term in, for example applying the stay of proceedings language of s. 69(1)(a) of the *BIA*."[21]

With respect, this does not follow. Dunphy J.'s finding that a proof of claim is a "proceeding" within the meaning of the *Limitations Act* is contrary to the express provision in s. 2 of that act. Additionally, the reference to the stay of proceedings under s. 69 of the *BIA* is misplaced. If filing a proof of claim were considered a "proceeding" in that sense, then it would be necessary for creditors to obtain an order lifting the stay of proceedings to file a proof of claim! Far from a purposive reading.

Finally, both Master Mills and Dunphy J. appear to read in a new type of ranking in bankruptcies that does not exist. In *Eyton I*, Master Mills implied that it would be contrary to the *BIA* to allow a statute-barred debt to receive dividends on a *pari passu* basis with other creditors, and in doing so, finds that the *BIA* provides for "fair and orderly distribution … among the creditors with proven and *enforceable* claims". [22] In *Eyton II,* Dunphy J. expressly states that a "statute-barred claim is *not* of the same rank as an enforceable claim…"[23]

With respect to both, the *BIA* does not distinguish between statute-barred debts and non-statute-barred debts and the concept of "enforceable" is not something that comes from the *BIA*. Section 121 simply refers to debts "to which the bankrupt is subject". The *Eyton* decisions appear to be premised on the assumption that "enforceable" is limited to "enforceable through court proceedings", which is simply too narrow a view of "enforceable".

Potential Impact

By interpreting the phrase "to which the bankrupt is subject" as "enforceable in court against the bankrupt", the *Eyton* decision may have inadvertently increased the administrative costs associated with distribution of the bankrupt's estate.

For debtors, query whether a debt is statute-barred should now factor into the statement of assets and liabilities? If a statute-barred debt is no longer a provable claim, then a debtor must be careful to ensure that it still meets the test for insolvency if that debt is not included. For creditors, care must be taken to ensure limitation periods are preserved, particularly during a contested application for bankruptcy order (as there is no suspension of limitation periods until the bankruptcy order has been issued).

The greatest impact may be on trustees and the administration of the estate. In evaluating proofs of claims, it appears a trustee will have an obligation to determine whether a claim may be statute-barred or not. In many cases, this may not be a difficult task. However, in some cases, this is likely to require additional investigations by the trustee and information to be provided by the bankrupt.

In addition, as any civil litigator will attest, limitation periods can be contested, and it is not always clear when a claim was discovered, and the limitation period began running. A trustee's disallowance of a claim based on a limitation period is likely to result in additional appeals by creditors, thereby driving up the cost of administration.

There is also likely to be confusion over set-off rights. If a creditor with a statute-barred claim is also a debtor to the bankrupt estate, will the creditor lose its ability to set-off against the amount owing to the bankrupt estate because the claim is no longer a provable claim?

It is believed that the decision will not be appealed. As such, until revisited by another court, the *Eyton* decision is good law in Ontario (and other provinces since the *BIA* is a federal statute). And arguably, in Ontario at least, if a tree falls in the forest, and no one is around to hear it, then it makes no sound.

[1] S.O. 2002, c. 24, Sched. B.

[2] *In re: John Trevor Eyton,* 2021 ONSC 1719, https://canlii.ca/t/jg3mb

[3] 2012 ONSC 376.

[4] *Limitations Act*, s. 1.

[5] *Limitations Act*, s. 23.

[6] *Temple* at paras. 19, 22 and 23.

[7] In *Temple*, Newbould J. did go on to consider whether the limitation period had been extended due to an acknowledgment of debt and found that the claim was not statute-barred in any event.

[8] RSC 1985, c B-3.

[9] Morton, In re; Morton, Bartling and Company Limited, Ex Parte, 1922 CanLII 146 (SKQB).

[10] *Reference Re the Debt Adjustment Act, 1937 (Alberta) Attorney-General for Alberta v. Attorney-General for Canada et al,* 1943 CanLII 371 (UKJCPC).

[11] *Farm Credit Corporation v. Dunwoody Limited,* 1988 ABCA 216.

[12] *Royal Bank of Canada v. Central Capital Corp.,* 1996 CanLII 1521.

[13] *Eyton I* at para. 7.

[14] *Eyton II* at para. 18.

[15] *Eyton II* at para. 18.

[16] *Eyton II* at para. 18.

[17] *Eyton II* at para. 19.

[18] *Eyton* at para. 21.

[19] RSC 1985, c C-44, s. 36(2).

[20] RSA 1980, c L-8, s. 41, now RSA 2000, c. L-7, s. 40.

[21] *Eyton II, supra* note 17; Although Dunphy J. refers to s. 69(1)(a), the section providing for a stay in a bankruptcy is 69.3(1).

[22] *Eyton I* at para. 11.

[23] *Eyton II* at para. 18.

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